

INTERMEDIATE (IPC) COURSE

STUDY MATERIAL

PAPER : 1

ACCOUNTING

MODULE – 1



BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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A WORD ABOUT STUDY MATERIAL

Accounting constitutes a very significant area of core competence for chartered accountants. The paper of 'Accounting' at Intermediate (IPC) level concentrates on conceptual understanding of the crucial aspects of accounting.

The Study Material has been designed having regard to the needs of home study and distance learning students. The students are expected to cover the entire syllabus and also practice solving the questions given in the practice manual on their own.

The main features of the Study Material are as under:

- The entire syllabus has been divided into fifteen chapters.
- The Study Material has been divided into three Modules for the easy handling and convenience of students.
- In each chapter, learning objectives have been stated. The learning objectives would enable you to understand the sequence of various aspects dealt within the chapter before going into the details so that you know the direction of your studies.
- In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic and can tackle the exercises.
- Many illustrations have been included in each chapter of the Study Material.
- In this revised study material, sincere efforts and care has been taken to incorporate the relevant amendments.

- In this revised edition, all the practical problems have been revisited and efforts have been taken to standardize the format of the solutions as far as possible.
- Flow charts have been inserted in Chapters at appropriate places for quick reference of students.
- Any theoretical additions made in the chapters have been highlighted in bold and italics while practical illustrations have been highlighted with grey shading in the Study Material for easy identification and quick reference.
- The Study Material has been revised in line with the relevant sections of the Companies Act, 2013 which have come into force.
- Feedback form is given in this study material wherein students are encouraged to give their feedback/suggestions.

These features would add value to the study material and aid the students in the learning process. In case you need any further clarification/guidance, you may send your queries at seema@icai.in, shilpa@icai.in; asha.verma@icai.in.

SIGNIFICANT ADDITIONS/MODIFICATIONS IN 2015 EDITION OVER 2014 EDITION

Chapter no./unit no.	Name of Chapter/	Name of Unit	Section/ Sub-section	Changes
Chapter 1: Unit 1	Accounting Standards	Introduction to Accounting Standards	Para 1.8 Convergence to IFRS in India	Para amended.
Chapter 1: Unit 2		Overview of Accounting standards	2.1 Status of Accounting Standards	Para related to Accounting standards and Income Tax Act, amended.
			2.4.2 Valuation of Inventories	Example added under Costs of conversion
			2.4.3 Cash Flow Statements	Example 1 added
			2.4.4 Depreciation Accounting	Matter added on amount and methods of depreciation. Example 5 added. Chart on assessment of depreciation inserted.
			2.4.6 Revenue Recognition	Chart on revenue recognition added.
			2.4.8 Accounting for investments	Example 1 added

			Miscellaneous illustrations	Illustration numbered 2, 5, 11 and 13 added.
Chapter 2- Unit 1	Financial Statements of Companies	Preparation of Financial Statements	1.7 Divisible Profits	Matter related to Dividend Distribution Tax amended. The calculation of grossing up of dividend incorporated in Illustrations 3 and 4.
Chapter 2- Unit 2		Cash Flow Statement	2.7 Illustrations	Illustration 9 added
Chapter 5	Internal Reconstruction		3. Entries in case of Internal Reconstruction	Illustration 7 added
Chapter 6	Amalgamation			Illustration 9 added
Chapter 11	Hire Purchase and Instalment Sale Transactions		6.2 When cash price and amount of instalment given, but rate of interest not given	Para amended and Illustration 4 added
Chapter 12	Investment Accounts			Illustration 6 added

SYLLABUS

PAPER 1: ACCOUNTING

(One paper – Three hours – 100 Marks)

Level of Knowledge : Working Knowledge

Objectives :

- (a) To lay a foundation for the preparation and presentation of financial statements,
- (b) To gain working knowledge of the principles and procedures of accounting and their application to different practical situations,
- (c) To gain the ability to solve simple problems and cases relating to sole proprietorship, partnership and companies and
- (d) To familiarize students with the fundamentals of computerized system of accounting.

Contents :

1. A General Knowledge of the framing of the accounting standards, national and international accounting authorities, adoption of international financial reporting standards

2. Accounting Standards

Working knowledge of:

- AS 1 : Disclosure of Accounting Policies
- AS 2 : Valuation of Inventories
- AS 3 : Cash Flow Statements
- AS 6 : Depreciation Accounting
- AS 7 : Construction Contracts (Revised 2002)
- AS 9 : Revenue Recognition
- AS 10 : Accounting for Fixed Assets
- AS 13 : Accounting for Investments
- AS 14 : Accounting for Amalgamations

3. Company Accounts

- (a) Preparation of financial statements – Profit and Loss Account, Balance Sheet and Cash Flow Statement, Statement of changes in Equity and Explanatory Notes.
- (b) Profit (Loss) prior to incorporation
- (c) Alteration of share capital, Conversion of fully paid shares into stock and stock into shares, Accounting for bonus issue
- (d) Simple problems on Accounting for business acquisition, Amalgamation and reconstruction (excluding problems of amalgamation on inter-company holding)

4. Average Due Date, Account Current, Self-Balancing Ledgers

5. Financial Statements of Not-for-Profit Organisations

6. Accounts from Incomplete Records

7. Accounting for Special Transactions

- (a) Hire purchase and instalment sale transactions
- (b) Investment accounts
- (c) Insurance claims for loss of stock and loss of profit.

8. Issues in Partnership Accounts

Final accounts of partnership firms – Admission, retirement and death of a partner including treatment of goodwill.

9. Accounting in Computerised Environment

An overview of computerized accounting system–Salient features and significance, Concept of grouping of accounts, Codification of accounts, Maintaining the hierarchy of ledger, Accounting packages and consideration for their selection, Generating Accounting Reports.

Note : If either old Accounting Standards (ASs), Announcements and Limited Revisions to ASs are withdrawn or new ASs, Announcements and Limited Revisions to ASs are issued by the Institute of Chartered Accountants of India in place of existing ASs, Announcements and Limited Revisions to ASs, the syllabus will accordingly exclude/include such new developments in place of the existing ones with effect from the date to be notified by the Institute.

STUDY PLAN – KEY TO EFFECTIVE LEARNING

The paper of Accounting at Intermediate (IPC) level aims to lay a foundation for the preparation and presentation of financial statements of sole proprietors, partnerships and companies and also expects students to have working knowledge of the principles and procedures of accounting and their application to different practical situations.

Know your syllabus

The study material of Paper 1 'Accounting' is divided in fifteen chapters/topics based on the curriculum. The topics covered under this paper include Accounting Standards; Financial Statements of Companies, Profit or Losses Prior to Incorporation, Bonus issue, Amalgamation and Internal Reconstruction (excluding problems on inter- company holding); Average Due Date, Account Current; Self Balancing Ledgers; Financial Statements of Not for Profit Organizations; Accounts from Incomplete Records; Hire Purchase and Instalment Sale Transactions; Investment Accounts; Insurance Claims for Loss of Stock and Loss of Profit; Issues in Partnership Accounts; Accounting in Computerized Environment.

The syllabus of Accounting has an appropriate mix of various topics of sole proprietorship, partnership and companies as the objective of the paper is to gain ability to solve simple problems related to different businesses entities.

Be familiar with the Knowledge inputs provided by the BoS

Once you are aware of the syllabus, the next step is to find and assimilate the knowledge inputs which have been provided by the ICAI / Board of Studies, to study the paper. For better understanding of the paper, Board of Studies has provided following knowledge inputs:

1. Study Material
2. Practice Manual
3. Suggested Answers
4. Revision Test Papers
5. Mock Test Papers
6. Students' Journal for academic updates

Now, after knowing the various knowledge inputs provided by the Board of Studies, you should plan your studies.

Planning – Time Management

You are advised to plan your studies on the basis of availability of time and the course contents. Planning for study of the paper 'Accounting' should be done in a manner which makes you go through the subject at least three times.

In Accounting, examination paper is purely practical based. Therefore, one has to do written practice of good number of questions on each topic. So, at the time of planning the study for accounting you should keep into mind the written practice of practical questions also. Considering the practical nature of the paper, start your studies from the day you receive the course material. As at Intermediate (IPC) level you do not have to undergo articleship training, therefore, it is suggested that you should study at least two hours a day. By doing so, you will be able to manage first round of complete study and two rounds of revision well before time. Your first round of study should be completed well in advance, that is, at least 3 months before your exam.

This is macro level planning about how to study but you should also plan at micro level i.e. time planning for each and every chapter in detail - when to start and by what time the chapter should be completed. Keep some time leverage as assimilation of the chapters may take more time than expected or planned.

Your second round of study i.e. your first revision should be over before one month of your exam. Your second revision should be in the last month before exam so that you will be in the position to remember all the concepts. These three rounds of study will help in boosting the confidence level for the subject and will make you mentally prepared to appear in the examination.

First round of study

As you are aware that the syllabus of 'Accounting' covers Accounting Standards as well as other topics, so your planning should be divided in two parts namely-

1. Accounting Standards
2. Other chapters of the course curriculum.

Every day when you start your study, first go through the concepts which you have read last day then start learning new concepts. Remember, out of sight, out of mind. Ideally your first study should be within 24 hours of initial reading, the second within 1 week of reading.

Part I- Accounting Standards

As accounting standards have been introduced to you for the first time in detail at this level, therefore, it is felt that we should give you an insight on accounting standards and how to study them.

Accounting standards are written policy documents issued by the ICAI. It covers the aspects of

- recognition,
- measurement,
- presentation and
- disclosure

of accounting transactions in the financial statements.

It is not necessary that each accounting standard deals with all the above aspects. There are some standards which deal only with disclosure part like AS 1, while AS 3 deals with the presentation aspect only. However, AS 2, 6, 7, 9, 10, 13 and 14 as specified in the syllabus deal with recognition and measurement principles in specific along with certain disclosure requirements.

Note: The examples mentioned above are with reference to accounting standards which form part of the syllabus of Intermediate (IPC) Paper 1 'Accounting'. Only nine accounting standards are included at Intermediate (IPC) level even though there are in effect 31 accounting standards.

Each accounting standard has certain paragraphs in bold and italics which deal with the main provisions. Other paragraphs which are not in bold and italics are explanation to the paragraphs in bold and italics. Together the bold and italics paragraphs and normal paragraphs constitute an Accounting standard.

Some accounting standards are generally applied to any business like AS 1, 2, 6, 9, 10 and 13 while some are industry/segment specific for example AS 7 (which will be applied only in case of construction contracts) and some situational like AS 14 'Accounting for Amalgamation' which states set of procedures to be followed at the time the company opt for merger.

In unit 2 of chapter 1 of our study material of 'Accounting', we have given the explanation/interpretation of the accounting standards specified in your syllabus. Also at the end of the study material, we have reproduced the bare text of these accounting standards for your reference. It is advised that after studying each standard explained in chapter 1 refer the bare text of accounting standard for building strong conceptual knowledge on the accounting standards specified in the syllabus.

Part II- Other Chapters

Once you study your accounting standard portion, you may study those chapters which are purely based on accounting standard. Such chapters are

Chapter 2 unit 2: Cash Flow Statement

Chapter 6: Amalgamation

Studying these chapters will revise your concepts on accounting standards which you have already studied in chapter 1 and will also make you understand and apply the provisions in the questions dealing with such standards.

Since, Intermediate (IPC) level is the second level of chartered accountancy course and we have a paper on 'Fundamentals of Accounting' at CPT level also, therefore, the chapters which apply the provisions studied at CPT level (to an extent) may be studied next. Such chapters are:

Chapter 9: Financial Statements of Not-for-Profit Organisations

Chapter 10: Accounts from Incomplete Records

Chapter 14: Issues in Partnership Accounts

You can then proceed studying other important chapters on company's accounts viz Preparation of financial statements of companies, Profit or loss prior to incorporation, Accounting for bonus issue and Internal reconstruction; one question on which is generally asked in the question paper. At the end, study small chapters on which question ranging from 4 to 8 marks are generally asked in the examination. Such chapters include average due date, account current, self balancing ledgers, hire-purchase and installment sale transactions, investment accounts, insurance claims for loss of stock and loss of profit and lastly accounting in computerized environment.

Chapter on 'Accounting in Computerized Environment' is a theory based chapter but question asked in the question paper is not a straight forward question. Your study should be application based so that you may analyze the requirements of the question and answer them in a desired manner.

Use of BoS Knowledge inputs in a systematic pattern

Step 1 Study material

To lay a strong foundation of the understanding of any particular topic, study material explains the concepts of each and every topic in detail with adequate illustrations. Study the underlying concepts and accounting treatment specified therein analytically before proceeding towards illustrations. Keep questioning yourself until you are absolutely clear on the topic. Solve the illustrations after understanding the topic. For example, in the chapter of Profit or loss prior to incorporation, one has to understand the reason why profit prior to incorporation is transferred to capital reserve and not to profit and loss account, what will be the treatment of loss prior to incorporation etc.

Step 2 Practice Manual

After solving the illustrations given in the study material, solve the questions given in the practice manual. Practice Manual is highly useful for the students appearing in the examination as it includes questions from past examinations which would facilitate in thorough understanding of the chapters explained in the study material. In accounting paper, it is very necessary that one should practice a good number of questions dealing with different adjustments. Practice Manual will help serve this purpose. Your first round of study should cover both Study Material and Practice Manual.

Second round of study

Step 3 Suggested answers

Your second round of study i.e. your first revision should cover practice of suggested answers of recent two to three examinations. Suggested answers of past few examinations give you an idea of what type of questions are asked in the examination and how to solve and present the solution for such questions in the examination. Solving the question paper in the examination situation will help you, not only in time management but will also give you the confidence to attempt different types of questions in the examination.

Step 4 Revision Test Papers (RTP)

After you complete revision of whole syllabus atleast once, you should solve the questions given in the RTP. For every examination, Board of Studies comes out with a Revision Test Paper. Revision Test Paper is issued for every attempt containing a fresh set of questions which will help you to evaluate your preparation level. RTP of Accounting is divided into two parts namely Part I: Recent amendments, notifications and announcements which are relevant for that particular examination and is not given in the study material or was not applicable in the immediate past examination. You will be able to know all such relevant information applicable for the exam at one place. Part II carries questions and answers for your practice. In Accounting, questions on each topic are given with full solution to enable you to get an insight on how to present the solutions in an orderly manner. In Accounting paper, RTP of past few attempts can also be referred subject to amendments for which you have to refer the latest Study Material and RTP.

Third round of study

Step 5 Mock Test Papers

After second revision of the complete syllabus, you may assess your preparation by taking mock tests conducted by various branches at their end. Also Mock test papers are hosted on the institute's website www.icai.org which you may download and solve within a time period of three hours.

Important points to be kept in mind:

1. Preparation of notes

Prepare concise notes in the first round of study itself. Your notes should be prepared in a manner, which supplements your understanding of the concept and the illustrations you have solved. You may either make a separate copy where you write down the important concepts of the chapter or can underline the important concepts in the book itself and read those underlined portion at the time of revision. You should also shortlist the illustrations to be revised again in your second and third round of study. Short listing of illustrations should be

based on the difficulty you faced while solving the question. Besides preparation of important points of the topic (which will help you to recapitulate the whole concepts), a summary of tricky points and adjustments gathered from the practice of various good illustrations may also be prepared which will help in grasping the intricate practical aspects. Such tricky points or adjustments should be cross linked with the concerned illustration number so that at the time of revision you not only study the accounting treatment but also refer the whole solution again. These notes may also be accompanied by the proforma of relevant accounts and diagrams so that at the later stages of preparation, the conceptual knowledge underlying different topics may be gained within minimum time and efforts without going through a number of books again.

2. Use of proper and prescribed format for presentation of accounts

There are some chapters which require the solution or financial statements to be presented in particular format. You should make it a practice to adopt the prescribed formats while solving and presenting the accounts of particular topics. For example: Financial Statements of companies should be in the format prescribed in the Schedule III to the Companies Act, 2013.

3. Recapitulation of previously read topics

The chapter of Partnership accounts was also there in the paper of 'Fundamentals of Accounting' at CPT level. Therefore, here at Intermediate (IPC) level, you are required to whet your skills on this topic. Also the concepts and provisions read at CPT level lays down the foundation for studying and understanding the topics specified at the Intermediate (IPC) level. For example, concept of revenue and capital receipt and expenditure is applied in every topic while preparing the financial statements of an entity. Similarly, valuation of inventory, accounting for depreciation etc. are some of the topics the concepts of which are applied in general to all entities.

4. Keep yourself continuously updated

We at Board of studies endeavor to update you with the latest amendments or notifications as and when they are issued. One of the sections in the Students' Journal is on 'Academic Update' which contains recent amendments in accounting also. You should develop a habit to read this continuously as it will help you in avoiding last moment pressure to acquaint yourself with all the relevant amendments. Also list of publication comprising of all relevant accounting standards and guidance notes are published well in time in the Students' Journal and the institute's website to apprise you with the applicability part of the same in the particular examination.

5. Keep in mind the inter-linking of various topics

The provisions of accounting standards have to be kept in mind and applied while studying the related chapter based on the particular accounting standard. If your concepts are clear relating to a particular standard, you should not face any problem in applying the same to solve

problems in an inter-connected chapter. Sometimes even though the chapter may not directly relate to an accounting standard, it may contain adjustments involving application of one or more standards.

We have made an attempt to explain with the help of tabular format given here under the manner in which concepts contained in the particular chapter of the study material have to be interlinked with the related provision in another chapter of the study material and read together:

Chapter / Unit No.	Name of the chapter/unit	Inter-linking
Chapter 1	Accounting standards	<ul style="list-style-type: none"> • Nine Accounting standards have been specified in this paper viz AS 1, 2, 3, 6, 7, 9, 10, 13 and 14. • AS 3 is on Cash Flow Statement. There is a separate unit in chapter 2 which deals with Cash Flow Statement. All the provisions of AS 3 will be applied while preparing the cash flow statement of a company. • Similarly, provisions of AS 14 'Accounting for Amalgamations' will be applied in chapter 6 'Amalgamation'. • Provisions of AS 13 'Accounting for Investments' will be applied to an extent in chapter 12 Investment Accounts. <p>For example value of closing balance of investment at the end of the accounting period will be cost or fair value whichever is less is as per para 14 of AS 13.</p>
Chapter 2	Financial statements of companies	<ul style="list-style-type: none"> • Format of Schedule III to the Companies Act explained in this chapter is to be applied in the financial statements of companies required to be prepared in chapter 4 'Accounting for Bonus Issue', chapter 5 'Internal Reconstruction' and chapter 6 'Amalgamation'. • Cash flow statement is to be prepared as per AS 3 explained in chapter 1

Chapter 3	Profit or loss prior to incorporation	This chapter applies the principle of periodicity read at CPT level in the paper of Fundamentals of Accounting.
Chapter 6	Amalgamation	Provisions of AS 14 should be kept in mind while studying this chapter.
Chapter 9 and 10	Financial Statements of Not - for - Profit organizations and Accounts from Incomplete Records	These chapters apply the provisions studied in the chapter 'Preparation of Final Accounts for Sole Proprietors' at CPT level.
Chapter 12	Investment Accounts	Provisions of AS 2 and 13 should also be remembered while valuing the closing balance of investment at the end of the accounting period.
Chapter 14	Issues in Partnership Accounts	In 'Fundamentals of Accounting' at CPT level, we had a chapter on partnership which dealt with profit and loss appropriation account of partnership firm, admission, retirement and death of a partner.

Other chapters though not specifically interlinked with any chapter but still apply the provisions already read earlier.

Tips for examination

General tips are already given in the first part of this booklet. However, we would like to also focus on following accounting related examination tips which you should keep in mind at the time of appearing for the examination:

1. Use of proper formats

Certain statutes prescribe specific formats for presentation of the accounts. You should take care of the same at the time of solving the questions in the exam. Accounts presented in the prescribed manner will help you in scoring due marks.

2. Adequate Working Notes

In accounts, your solution is generally divided in two parts viz- main solution and working notes. Working notes form part of your solution and carries marks. Therefore, it is advised that calculations made on your calculator should also be written in your answer sheet as working note, wherever required, neatly and precisely. Also your working note should be cross referenced with the figure used in the main solution so that examiner can easily understand that how you have arrived at the particular figure.

3. Answer the questions with due emphasis on the provisions of Accounting Standards

Support your answers/conclusions with proper reasoning. Answers for questions based on accounting standards should be supported with provisions of that accounting standard rather than a mere common sense or guess work. It is not required to quote paragraph number of Accounting standard but you are expected to quote accounting standard number alongwith the name of the standard. However, if you state, paragraph number of accounting standard, then it will add value to the solution and will also help create a good impression in the mind of the examiner. You should quote number of accounting standard or name only when you are sure. It is better not to quote than to misquote the accounting standard number.

4. State the assumption clearly

In case a question leaves room for making an assumption and there is a possibility of more than one assumption, it is important to clearly state the assumption you have taken and solve the question accordingly.

Happy Reading and Best Wishes!

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Accounting Standards

Unit 1 : Introduction to Accounting Standards

Learning objectives

After studying this unit you will be able to:

- ◆ Understand the concept of Accounting Standards.
- ◆ Grasp the objectives, benefits and limitations of Accounting Standards.
- ◆ Learn the standards setting process.
- ◆ Familiarize with the overview of Accounting Standards in India.
- ◆ Recognize the International Accounting Standard Authorities.
- ◆ Appreciate the adoption of International Financial Reporting Standards as global standards.

1.1 Introduction

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. Accounting Standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises.

Accounting Standards deal with the issues of

- (i) recognition of events and transactions in the financial statements,
- (ii) measurement of these transactions and events,
- (iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and
- (iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these

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financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

Accounting Standards standardize diverse accounting policies with a view to

- (i) Eliminate the non-comparability of financial statements and thereby improving the reliability of financial statements, to the maximum possible extent, and
- (ii) Provide a set of standard accounting policies, valuation norms and disclosure requirements.

The standard policies are intended to reflect a consensus on accounting policies to be used in different identified area, e.g. inventory valuation, capitalisation of costs, depreciations and amortisations etc. Since it is not possible to prescribe a single set of policies in any area to be appropriate for all enterprises for all time, it is not enough to comply with the standards and state that they have been followed; one must also disclose the accounting policies actually used in preparation of financial statements. (See AS 1, Disclosure of Accounting Policies given in Appendix I of this Module). For example, an enterprise should disclose which of the permitted cost formula (FIFO, Weighted Average etc.) has actually been used for ascertaining inventory costs.

In addition to improving credibility of accounting data, standardisation of accounting procedures improves comparability of financial statements, both intra-enterprise and inter-enterprise. Such comparisons are very effective and most widely used tools for assessment of enterprise performances by users of financial statements for taking economic decisions, e.g. whether or not to invest, whether or not to lend and so on.

The intra-enterprise comparison involves comparison of financial statements of same enterprise over number of years. The intra-enterprise comparison is possible if the enterprise uses same accounting policies every year in drawing up its financial statements. For this reason, AS 1 requires disclosure of changes in accounting policies.

The inter-enterprise comparison involves comparison of financial statements of different enterprises for same accounting period. This is possible only when comparable enterprises use same accounting policies in preparation of respective financial statements. The disclosure of accounting policies allows a user to make appropriate adjustments while comparing the financial statements.

Another advantage of standardisation is reduction of scope for *creative accounting*. The creative accounting refers to twisting of accounting policies to produce financial statements favourable to a particular interest group. For example, it is possible to overstate profits and assets by capitalising revenue expenditure or to understate them by writing off a capital expenditure against revenue of current accounting period. Such practices can be curbed only by framing rules for capitalisation, particularly for the borderline cases where it is possible to have divergent views. The accounting standards do just that.

In brief, the accounting standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements. Good financial reporting not only promotes healthy financial markets, it also helps

to reduce the cost of capital because investors can have faith in financial reports and consequently perceive lesser risks.

1.2 Standards Setting Process

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The composition of ASB includes, representatives of industries (namely, ASSOCHAM, CII, FICCI), regulators, academicians, government departments etc. Although ASB is a body constituted by the Council of the ICAI, it (ASB) is independent in the formulation of accounting standards and Council of the ICAI is not empowered to make any modifications in the draft accounting standards formulated by ASB without consulting with the ASB.

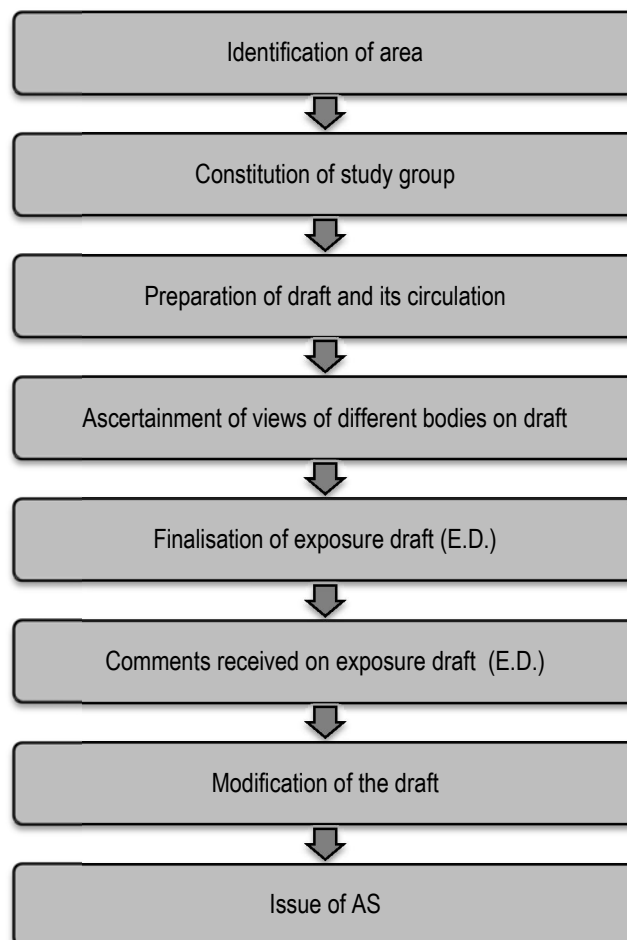
The standard-setting procedure of Accounting Standards Board (ASB) can be briefly outlined as follows:

- ◆ Identification of broad areas by ASB for formulation of AS.
- ◆ Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.
- ◆ Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.
- ◆ Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.
- ◆ Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
- ◆ Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.
- ◆ Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- ◆ Consideration of the final draft of the proposed standard and by the Council of the ICAI,

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and if found necessary, modification of the draft in consultation with the ASB is done. The accounting standard on the relevant subject is then issued by the ICAI.

Standard – Setting Process



Earlier, ASB used to issue Accounting Standard Interpretations which address questions that arise in course of application of standard. These were, therefore, issued after issuance of the relevant standard. Authority of the accounting standard interpretation (ASIs) was same as that of the accounting standard (AS) to which it relates. However, after notification of accounting standards by the Central government for the companies, where the consensus portion of ASI was merged as 'Explanation' to the relevant paragraph of the accounting standard, the council of ICAI also decided to merge the consensus portion of ASI as 'Explanation' to the relevant paragraph of the accounting standard issued by them. This initiative was taken by the council of the ICAI to harmonise both the set of standards i.e. accounting standards issued by the ICAI and accounting standards notified by the central government.

1.3 Benefits and Limitations

Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards the accountant has following benefits:

- (i) **Standardisation of alternative accounting treatments:** Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.
- (ii) **Requirements for additional disclosures:** There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.
- (iii) **Comparability of financial statements:** The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

However, there are some limitations of setting of accounting standards:

- (i) **Difficulties in making choice between different treatments:** Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) **Lack of flexibilities:** There may be a trend towards rigidity and away from flexibility in applying the accounting standards.
- (iii) **Restricted scope:** Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

1.4 How many Accounting Standards?

The council of the Institute of Chartered Accountants of India has, so far, issued thirty two Accounting Standards. However, AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are 31 Accounting Standards at present.

The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

1.5 Need for Convergence towards Global Standards

The last decade has witnessed a sea change in the global economic scenario. The emergence of trans-national corporations in search of money, not only for fuelling growth, but to sustain

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on going activities has necessitated raising of capital from all parts of the world, cutting across frontiers.

Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin. Therefore translation and re-instatements are of utmost importance in a world that is rapidly globalising in all ways. In themselves also, the accounting standards and principle need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organizations.

International analysts and investors would like to compare financial statements based on similar accounting standards, and this has led to the growing support for an internationally accepted set of accounting standards for cross-border filings. The harmonization of financial reporting around the world will help to raise confidence of investors generally in the information they are using to make their decisions and assess their risks.

Also a strong need was felt by legislation to bring about uniformity, rationalization, comparability, transparency and adaptability in financial statements. Having a multiplicity of accounting standards around the world is against the public interest. If accounting for the same events and information produces different reported numbers, depending on the system of standards that are being used, then it is self-evident that accounting will be increasingly discredited in the eyes of those using the numbers. It creates confusion, encourages error and facilitates fraud. The cure for these ills is to have a single set of global standards, of the highest quality, set in the interest of public. Global Standards facilitate cross border flow of money, global listing in different bourses and comparability of financial statements.

The convergence of financial reporting and accounting standards is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital market stakeholders. It improves the ability of investors to compare investments on a global basis and thus lowers their risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements say reinstatement of financial statements. It has the potential to create a new standard of accountability and greater transparency, which are values of great significance to all market participants including regulators. It reduces operational challenges for accounting firms and focuses their value and expertise around an increasingly unified set of standards. It creates an unprecedented opportunity for standard setters and other stakeholders to improve the reporting model. For the companies with joint listings in both domestic and foreign country, the convergence is very much significant.

1.6 International Accounting Standard Board

With a view of achieving these objectives, the London based group namely the International Accounting Standards Committee (IASC), responsible for developing International Accounting Standards, was established in June, 1973. It is presently known as International Accounting

Standards Board (IASB), The IASC comprises the professional accountancy bodies of over 75 countries (including the Institute of Chartered Accountants of India). Primarily, the IASC was established, in the public interest, to formulate and publish, International Accounting Standards to be followed in the presentation of audited financial statements. International Accounting Standards were issued to promote acceptance and observance of International Accounting Standards worldwide. The members of IASC have undertaken a responsibility to support the standards promulgated by IASC and to propagate those standards in their respective countries.

Between 1973 and 2001, the International Accounting Standards Committee (IASC) released International Accounting Standards. Between 1997 and 1999, the IASC restructured their organisation, which resulted in formation of International Accounting Standards Board (IASB). These changes came into effect on 1st April, 2001. Subsequently, IASB issued statements about current and future standards: IASB publishes its Standards in a series of pronouncements called International Financial Reporting Standards (IFRS). However, IASB has not rejected the standards issued by the ISAC. Those pronouncements continue to be designated as "International Accounting Standards" (IAS).

1.7 International Financial Reporting Standards as Global Standards

The term IFRS comprises IFRS issued by IASB; IAS issued by International Accounting Standards Committee (IASC); Interpretations issued by the Standard Interpretations Committee (SIC) and the IFRS Interpretations Committee of the IASB.

International Financial Reporting Standards (IFRSs) are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving toward adopting them to some extent. Large number of authorities requires public companies to use IFRS for stock-exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports. So over the next few years, thousands of companies will adopt the international standards. This requirement will affect about 7,000 enterprises, including their subsidiaries, equity investors and joint venture partners. The increased use of IFRS is not limited to public-company listing requirements or statutory reporting. Many lenders and regulatory and government bodies are looking to IFRS to fulfil local financial reporting obligations related to financing or licensing.

1.8 Convergence to IFRS in India

Increasingly, Indian accountants and businessmen feel the need for convergence with IFRS. Capital markets provide an important explanation for this change. Some Indian companies are already listed on overseas stock exchanges and many more will list in the future. Internationally acceptable accounting standards are becoming the language of communication for Indian companies.

Also, the recent stream of overseas acquisitions by Indian companies makes a compelling case for adoption of high quality standards to convince foreign enterprises about the financial

standing as also the disclosure and governance standards of Indian acquirers. Convergence with IFRS would require several changes in Indian laws and decision processes.

In India, the Institute of Chartered Accountants of India (ICAI) works towards convergence by considering the application of IFRS in Indian corporate environment of its Standards with Global Standards. Recognizing the growing need of full convergence of Indian Accounting Standards with IFRSs, ICAI constituted a Task Force to examine various issues involved. Full convergence involves adoption of IFRSs in the same form as that issued by the IASB. While formulating the Accounting Standards, ICAI recognizes the legal and other conditions prevailing in India and makes deviations from the corresponding IFRSs.

The Accounting Standard Board in consultation with the Ministry of Corporate Affairs (MCA) for convergence of Indian Accounting Standards with International Financial Reporting Standards (IFRS), has decided that there will be two separate sets of Accounting Standards viz. (i) Indian Accounting Standards converged with the IFRS – standards which are being converged by eliminating the differences of the Indian Accounting Standards vis-à-vis IFRS (known as Ind AS) and (ii) Existing Notified Accounting Standards.

Recently, the MCA has notified Roadmap for applicability of IFRS converged Indian Accounting (Ind AS) vide Notification No. G.S.R.....(E) dated 16 February, 2015, for compliance by the class of companies specified in the said roadmap. The notification has been uploaded on www.mca.gov.in along with the thirty nine (39) Indian Accounting Standards (Ind AS). The companies may voluntarily comply with Ind ASs for the accounting periods beginning on or after from 1st April, 2015. However, it is mandatory for certain class of companies as specified in the notification to comply with Ind ASs for the accounting periods beginning on or after from 1st April, 2016 onwards.

Unit 2: Overview of Accounting Standards

Learning objectives

After studying this unit you will be able to:

- ◆ Comprehend the status and applicability of accounting standards.
- ◆ Know the scope of various accounting standards.
- ◆ Understand the provisions of the given Accounting Standards.
- ◆ Relate relevant Accounting Standards at various situations and apply them accordingly.
- ◆ Solve the practical problems based on application of Accounting Standards.

2.1 Status of Accounting Standards

It has already been mentioned in unit one of this chapter that the standards are developed by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India and are issued under the authority of its Council. The institute not being a legislative body can enforce compliance with its standards only by its members. Also, the standards cannot override laws and local regulations. The accounting standards are nevertheless made mandatory from the dates specified in respective standards and are generally applicable to all enterprises, subject to certain exception as stated below. The implication of mandatory status of an accounting standard depends on whether the statute governing the enterprise concerned requires compliance with the standard.

In assessing whether an accounting standard is applicable, one must find correct answer to the following three questions.

- (a) Does it apply to the enterprise concerned? If yes, the next question is:
- (b) Does it apply to the financial statement concerned? If yes, the next question is:
- (c) Does it apply to the financial item concerned?

The preface to the statements of accounting standards answers the above questions.

Enterprises to which the accounting standards apply

Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, whether or not profit oriented and even if established for charitable or religious purposes. Accounting Standards however, do not apply to enterprises solely carrying on the activities, which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise were considered to be commercial, industrial or business in nature, the

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Accounting Standards would apply to all its activities including those, which are not commercial, industrial or business in nature.

Implication of mandatory status

Where the statute governing the enterprise does not require compliance with the accounting standards, e.g. a partnership firm, the mandatory status of an accounting standard implies that, in discharging their attest functions, the members of the Institute are required to examine whether the financial statements are prepared in compliance with the applicable accounting standards. (See Scheme of Applicability of Accounting Standards given in para 2.3) In the event of any deviation from the accounting standards, they have the duty to make adequate disclosures in their reports so that the users of financial statements may be aware of such deviations. It should nevertheless be noted that responsibility for the preparation of financial statements and for making adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.

Section 129 (1) of the Companies Act, 2013 requires companies to present their financial statements in accordance with the accounting standards notified under Section 133 of the Companies Act, 2013 (See Note 1). Also, the auditor is required by section 143(3)(e) to report whether, in his opinion, the financial statements of the company audited, comply with the accounting standards referred to in section 133 of the Companies Act, 2013. Where the financial statements of a company do not comply with the accounting standards, the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviations as per Section 129(5) of the Companies Act, 2013. Provided also that the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose—

- (a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;
- (b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;
- (c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;
- (d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

Note: As per the Companies Act, 2013, the Central Government may prescribe standards of accounting or addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with NACAS. Till date, the Central Government has notified all the existing accounting standards* except AS 30, 31 and 32 on Financial Instruments.

* It may be noted that AS 8 'Research and Development' has already been withdrawn consequent to issuance of AS 26 'Intangible Assets'.

Financial items to which the accounting standards apply

The Accounting Standards are intended to apply only to items, which are material. An item is considered material, if its omission or misstatement is likely to affect economic decision of the user. Materiality is not necessarily a function of size; it is the information content i.e. the financial item which is important. A penalty of ₹ 50,000 paid for breach of law by a company can seem to be a relatively small amount for a company incurring crores of rupees in a year, yet is a material item because of the information it conveys. The materiality should therefore be judged on case-to-case basis. If an item is material, it should be shown separately instead of clubbing it with other items. For example it is not appropriate to club the penalties paid with legal charges.

Accounting Standards and Income tax Act, 1961

Accounting standards intend to reduce diversity in application of accounting principles. They improve comparability of financial statements and promote transparency and fairness in their presentation. Deductions and exemptions allowed in computation of taxable income on the other hand, is a matter of fiscal policy of the government.

Thus, an expense required to be charged against revenue by an accounting standard does not imply that the same is always deductible for income tax purposes. For example, depreciation on assets taken on finance lease is charged in the books of lessee as per AS 19 but depreciation for tax purpose is allowed to lessor, being legal owner of the asset, rather than to lessee. Likewise, recognition of revenue in the financial statements cannot be avoided simply because it is exempted under section 10 of the Income Tax Act, 1961.

Under section 145(1) of the Income-tax Act, 1961, income chargeable under the heads "Profits and gains of business or profession" or "Income from other sources" shall be computed in accordance with either the cash or mercantile system of accounting regularly employed by the assessee. Section 145(2), of Income-tax Act, 1961 empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assesseees or in respect of any class of income. Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2) of Income-tax Act, 1961, notified ten income computation and disclosure standards (ICDSs) to be followed by all assesseees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources". This notification shall come into force with effect from 1st April, 2015, and shall accordingly apply to the A.Y. 2016-17 and subsequent assessment years.

All the notified ICDSs are applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts. In the case of conflict between the provisions of the Income-tax Act, 1961 and the notified ICDSs, the provisions of the Act shall prevail to that extent. The following table contains the list of notified ICDSs:

ICDS-1	Accounting Policies
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ICDS-2	<i>Valuation of Inventories</i>
ICDS-3	<i>Construction Contracts</i>
ICDS-4	<i>Revenue Recognition</i>
ICDS-5	<i>Tangible fixed Assets</i>
ICDS-6	<i>The Effects of changes in Foreign Exchange Rates</i>
ICDS-7	<i>Government Grants</i>
ICDS-8	<i>Securities</i>
ICDS-9	<i>Borrowing Cost</i>
ICDS-10	<i>Provisions, Contingent Liabilities and Contingent Assets</i>

2.2 Applicability of Accounting Standards

For the purpose of compliance of the accounting Standards, the ICAI had already issued an announcement on 'Criteria for Classification of Entities and Applicability of Accounting Standards' in year 2003. As per the announcement, entities were classified into three levels. Level II entities and Level III entities as per the said Announcement were considered to be Small and Medium Entities (SMEs).

However, when the accounting standards were notified by the Central Government in consultation with the National Advisory Committee on Accounting Standards, the Central Government also issued the 'Criteria for Classification of Entities and Applicability of Accounting Standards' for the companies. It is pertinent to note that the accounting standards notified by the government were mandatory for the companies since it was notified under the Act.

According to the 'Criteria for Classification of Entities and Applicability of Accounting Standards' as issued by the Government, there are two levels, namely, Small and Medium-sized Companies (SMCs) as defined in the Companies (Accounting Standards) Rules, 2006 and companies other than SMCs. Non-SMCs are required to comply with all the Accounting Standards in their entirety, while certain exemptions/ relaxations have been given to SMCs.

Consequent to certain differences in the criteria for classification of the levels of entities as issued by the ICAI and as notified by the Central Government for companies, the Accounting Standard Board of the ICAI decided to revise its "Criteria for Classification of Entities and Applicability of Accounting Standards' and make the same applicable only to non-corporate entities. Though the classification criteria and applicability of accounting standards has been largely aligned with the criteria prescribed for corporate entities, it was decided to continue with the three levels of entities for non-corporate entities vis-à-vis two levels prescribed for corporate entities as per the government notification.

'Criteria for Classification of Entities and Applicability of Accounting Standards' for corporate entities and non-corporate entities have been explained in the coming paragraphs.

No relaxation was given to Level II and III enterprises in respect to recognition and measurement principles. Relaxations were provided with regard to disclosure requirements.

2.2.1 Criteria for classification of non-corporate entities as decided by the Institute of Chartered Accountants of India

Level I Entities

Non-corporate entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

- (i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.
- (ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.
- (iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.
- (iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.
- (v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

- (i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees one crore but does not exceed rupees fifty crore in the immediately preceding accounting year.
- (ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.
- (iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities.

Additional requirements

- (1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.
- (2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the

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previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

- (3) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.
- (4) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which it has availed the exemption or relaxation.
- (5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.
- (6) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard: Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.
- (7) In respect of Accounting Standard (AS) 15, *Employee Benefits*, exemptions/ relaxations are available to Level II and Level III entities, under two sub-classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

2.2.2 Criteria for classification of Companies as per the Companies (Accounting Standards) Rules, 2006

Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

“Small and Medium Sized Company” (SMC) means, a company-

- (i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
- (ii) which is not a bank, financial institution or an insurance company;
- (iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

- (iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
- (v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

Companies not falling within the definition of SMC are considered as Non- SMCs.

Instructions

A. General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:-
 - 1.1 The SMC which does not disclose certain information pursuant to the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an SMC and has complied with the Accounting Standards insofar as they are applicable to an SMC on the following lines:

“The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company.”
 - 1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.
 - 1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.
 - 1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.
 - 1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

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Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

B. Other Instruction

Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below:

“5. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods.”

2.2.3 Applicability of Accounting Standards to Companies

2.2.3.1 Accounting Standards applicable to all companies in their entirety for accounting periods commencing on or after 7th December, 2006

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 18	Related Party Disclosures
AS 22	Accounting for Taxes on Income
AS 24	Discontinuing Operations
AS 26	Intangible Assets

2.2.3.2 Exemptions or Relaxations for SMCs as defined in the Notification

(A) Accounting Standards not applicable to SMCs in their entirety:

AS 3 Cash Flow Statements.

AS 17 Segment Reporting

(B) *Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs*:*

- (i) AS 21, Consolidated Financial Statements
- (ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements
- (iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(C) *Accounting Standards** in respect of which relaxations from certain requirements have been given to SMCs:*

- (i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)
- (ii) AS 19, Leases
- (iii) AS 20, Earnings Per Share
- (iv) AS 28, Impairment of Assets
- (v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

(D) *AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g, quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.*

2.2.4 Applicability of Accounting Standards to Non-corporate Entities

2.2.4.1 Accounting Standards applicable to all Non-corporate Entities in their entirety (Level I, Level II and Level III)

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting

* AS 21, AS 23 and AS 27 (relating to consolidated financial statements) are required to be complied with by a company if the company, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

** The exemption provisions contained in these standards have not been detailed since these standards do not form part of syllabus of Intermediate (IPC) Paper-1 Accounting.

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AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 22	Accounting for Taxes on Income
AS 26	Intangible Assets

2.2.4.2 Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) *Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:*

AS 3	Cash Flow Statements
AS 17	Segment Reporting

(B) *Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:*

AS 3	Cash Flow Statements
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 24	Discontinuing Operations

(C) *Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities*:*

(i)	AS 21, Consolidated Financial Statements
(ii)	AS 23, Accounting for Investments in Associates in Consolidated Financial Statements
(iii)	AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

* AS 21, AS 23 and AS 27 (to the extent these standards relate to preparation of consolidated financial statements) are required to be complied with by a non-corporate entity if the non-corporate entity, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

(D) Accounting Standards** in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):

- (i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)
- (ii) AS 19, Leases
- (iii) AS 20, Earnings Per Share
- (iv) AS 28, Impairment of Assets
- (v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

(E) AS 25, *Interim Financial Reporting*, does not require a non-corporate entity to present interim financial report. It is applicable only if a non corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.

2.3 List of Accounting Standards

Following is the list of Accounting Standards with their respective date of applicability:

AS No.	AS Title	Date
1	Disclosure of Accounting Policies	01/04/1993
2	Valuation of Inventories (Revised)	01/04/1999
3	Cash Flow Statement (Revised)	01/04/2001
4	Contingencies and Events Occurring after the Balance Sheet Date	01/04/1998
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (Revised)	01/04/1996
6	Depreciation Accounting (Revised)	01/04/1995
7	Construction Contracts (Revised)	01/04/2002
8	Research & Development	Now included in AS 26
9	Revenue Recognition	01/04/1993
10	Accounting for Fixed Assets	01/04/1993
11	The Effects of Changes in Foreign Exchange Rates	01/04/2004

** The exemption provisions contained in these standards have not been detailed since these standards do not form part of syllabus of Intermediate (IPC) Paper-1 Accounting.

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	(Revised)	
12	Accounting for Government Grants	01/04/1994
13	Accounting for Investments	01/04/1995
14	Accounting for Amalgamations	01/04/1995
15	Employee Benefits	01/04/2006
16	Borrowing Costs	01/04/2000
17	Segment Reporting	01/04/2001
18	Related Party Disclosures	01/04/2001
19	Leases	01/04/2001
20	Earnings Per Share	01/04/2001
21	Consolidated Financial Statement	01/04/2001
22	Accounting for Taxes on Income	01/04/2006
23	Accounting for Investment in Associates in Consolidated Financial Statements	01/04/2002
24	Discontinuing Operations	01/04/2004
25	Interim Financial Statement	01/04/2002
26	Intangible Assets	01/04/2003
27	Financial Reporting of Interests in Joint Ventures	01/04/2002
28	Impairment of Assets	01/04/2008
29	Provisions, Contingent Liabilities and Contingent Assets	01/04/2004
30	Financial Instruments: Recognition and Measurement	01/04/2009 (Recommendatory)
31	Financial Instruments: Presentation	01/04/2009 (Recommendatory)
32	Financial Instruments: Disclosure	01/04/2009 (Recommendatory)

Note: Accounting Standards 1, 2, 3, 6, 7, 9, 10, 13 and 14 are covered in the Intermediate (IPC) Course (Gr-I) syllabus and have been discussed in detail in the later paras.

2.4 Overview

2.4.1 Disclosure of Accounting Policies (AS 1)

Irrespective of extent of standardization, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard.

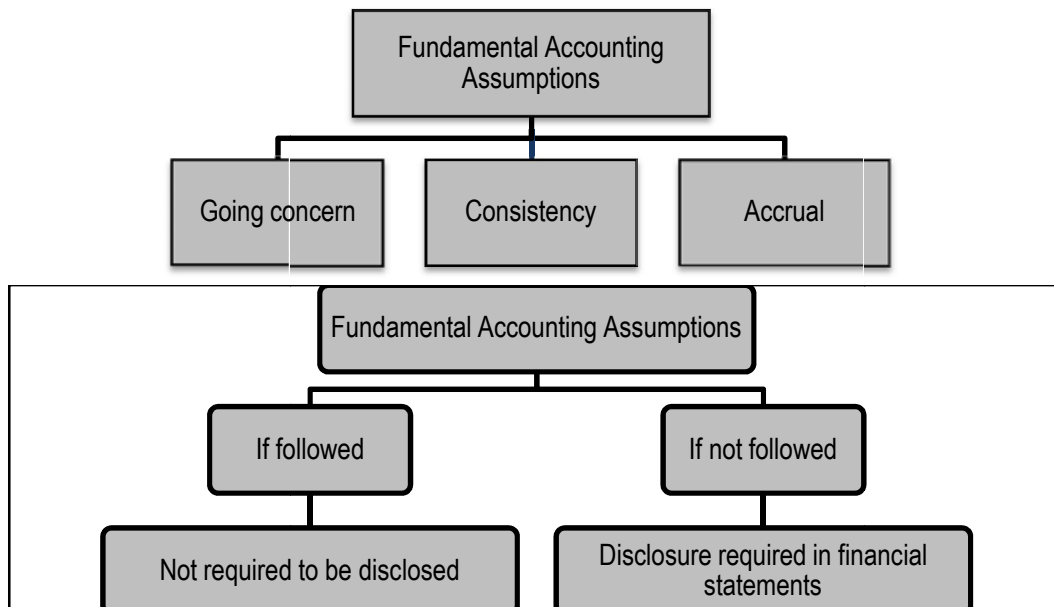
Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time.

The accounting standards therefore permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

The purpose of Accounting Standard 1, Disclosure of Accounting Policies, is to promote better understanding of financial statements by requiring disclosure of significant accounting policies in orderly manner. As explained in the preceding paragraph, such disclosures facilitate more meaningful comparison between financial statements of different enterprises for same accounting periods. The standard also requires disclosure of changes in accounting policies such that the users can compare financial statements of same enterprise for different accounting periods.

Accounting Standard 1, Disclosure of Accounting Policies, was first issued November 1979. It came into effect in respect of accounting periods commencing on or after April 1, 1991. The standard applies to all enterprises.

Fundamental Accounting Assumptions (Paragraph 10)



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Going Concern: The financial statements are normally prepared on the assumption that an enterprise will continue its operations in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations. Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities.

Consistency: The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The consistency improves comparability of financial statements through time. An accounting policy can be changed if the change is required (i) by a statute (ii) by an accounting standard (iii) for more appropriate presentation of financial statements.

Accrual basis of accounting: Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid. Accrual basis ensures better matching between revenue and cost and profit/loss obtained on this basis reflects activities of the enterprise during an accounting period, rather than cash flows generated by it.

While accrual basis is a more logical approach to profit determination than the cash basis of accounting, it exposes an enterprise to the risk of recognising an income before actual receipt. The accrual basis can therefore overstate the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital. For this reason, accounting standards require that no revenue should be recognised unless the amount of consideration and actual realisation of the consideration is reasonably certain.

Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting as illustrated below. Section 209(3)(b) of the Companies Act makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated.

Accounting Policies

The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

Accountant has to make decisions from various options for recording or disclosing items in the books of accounts e.g.

Items to be disclosed	Method of disclosure or valuation
Inventories	FIFO, Weighted Average etc.
Cash Flow Statement	Direct Method, Indirect Method
Depreciation	Straight Line Method, Reducing Balance Method, Depletion Method etc.

This list is exhaustive i.e. endless. For every item right from valuation of assets and liabilities to recognition of revenue, providing for expected losses, for each event, accountant need to form principles and evolve a method to adopt those principles. This method of forming and applying accounting principles is known as accounting policies.

As we say that accounts is both science and art. It is a science because we have some tested accounting principles, which are applicable universally, but simultaneously the application of these principles depends on the personal ability of each accountant. Since different accountants may have different approach, we generally find that in different enterprise under same industry, different accounting policy is followed. Though ICAI along with Government is trying to reduce the number of accounting policies followed in India but still it cannot be reduced to one. Accounting policy adopted will have considerable effect on the financial results disclosed by the financial statements; it makes it almost difficult to compare two financial statements.

Selection of Accounting Policy

Financial Statements are prepared to portray a true and fair view of the performance and state of affairs of an enterprise. In selecting a policy, alternative accounting policies should be evaluated in that light. In particular, major considerations that govern selection of a particular policy are:

Prudence: In view of uncertainty associated with future events, profits are not anticipated, but losses are provided for as a matter of conservatism. Provision should be created for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. The exercise of prudence in selection of accounting policies ensure that (i) profits are not overstated (ii) losses are not understated (iii) assets are not overstated and (iv) liabilities are not understated.

Example 1

The most common example of exercise of prudence in selection of accounting policy is the policy of valuing inventory at lower of cost and net realisable value.

Suppose a trader has purchased 500 units of certain article @ ₹ 10 per unit. He sold 400 articles @ ₹ 15 per unit. If the net realisable value per unit of the unsold article is ₹ 15, the trader shall value his stock at ₹ 10 per unit and thus ignoring the profit ₹ 500 that he may earn in next accounting period by selling 100 units of unsold articles. If the net realisable value per unit of the unsold article is ₹ 8, the trader shall value his stock at ₹ 8 per unit and thus recognising possible loss ₹ 200 that he may incur in next accounting period by selling 100 units of unsold articles.

Profit of the trader if net realisable value of unsold article is ₹ 15

$$= \text{Sale} - \text{Cost of goods sold} = (400 \times ₹ 15) - (500 \times ₹ 10 - 100 \times ₹ 10) = ₹ 2,000$$

Profit of the trader if net realisable value of unsold article is ₹ 8

$$= \text{Sale} - \text{Cost of goods sold} = (400 \times ₹ 15) - (500 \times ₹ 10 - 100 \times ₹ 8) = ₹ 1,800$$

Example 2

Exercise of prudence does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses. Suppose a company is facing a damage suit. No provision for damages should be recognised by a charge against profit, unless the probability of losing the suit is more than the probability of not losing it.

Substance over form: Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

Materiality: Financial statements should disclose all 'material items, i.e. the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases quantitative limits of materiality is specified. A few of such cases are given below:

- (a) A company shall disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or ₹1,00,000 whichever is higher (Refer general Instructions for preparation of Statement of Profit and Loss in Schedule III to the Companies Act, 2013).
- (b) A company shall disclose in Notes to Accounts, shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held. (Refer general Instructions for Balance Sheet in Schedule III to the Companies Act, 2013).

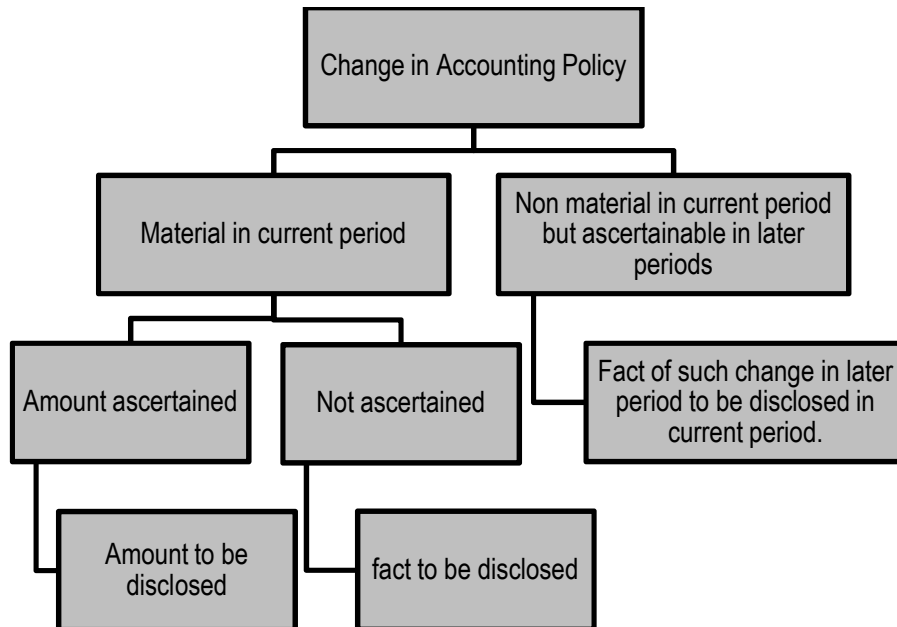
Manner of disclosure: All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed

The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

Note: Being a part of the financial statement, the opinion of auditors shall cover the disclosures of accounting policies.

Disclosure of Changes in Accounting Policies

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in a later period should be disclosed. In the case of a change in accounting policies, which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

**Example 3**

A simple disclosure that an accounting policy has been changed is not of much use for a reader of a financial statement. The effect of change should therefore be disclosed wherever ascertainable. Suppose a company has switched over to weighted average formula for ascertaining cost of inventory, from the earlier practice of using FIFO. If the closing inventory by FIFO is ₹ 2 lakh and that by weighted average formula is ₹ 1.8 lakh, the change in accounting policy pulls down profit and value of inventory by ₹ 20,000. The company may disclose the change in accounting policy in the following manner:

'The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year the company has changed to weighted average formula, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced profit and value of inventory by ₹ 20,000'.

A change in accounting policy is to be disclosed if the change is reasonably expected to have material effect in future accounting periods, even if the change has no material effect in the current accounting period.

The above requirement ensures that all important changes in accounting policies are actually disclosed. Suppose a company makes provision for warranty claims based on estimated costs of materials and labour. The company changed the policy in 2014-15 to include overheads in estimating costs for servicing warranty claims. If value of warranty sales in 2014-15 is not significant, the change in policy will not have any material effect on financial statements of 2014-15. Yet, the company must disclose the change in accounting policy in 2014-15 because the change can affect future accounting periods when value of warranty sales may rise to a significant level. If the disclosure is not made in 2014-15, then no disclosure in future years

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will be required. This is because an enterprise has to disclose changes in accounting policies in the year of change only.

Disclosure of deviations from fundamental accounting assumptions

If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The deviation from the principle of consistency therefore means a change in accounting policy, the disclosure requirements for which are covered by paragraph 26.

2.4.2 Valuation of Inventory (AS 2)

The cost of closing inventory, e.g. cost of closing stock of raw materials, closing work-in-progress and closing finished stock, is a part of costs incurred in the current accounting period that is carried over to next accounting period. Likewise, the cost of opening inventory is a part of costs incurred in the previous accounting period that is brought forward to current accounting period.

Since inventories are assets, and assets are resources expected to cause flow of future economic benefits to the enterprise, the costs to be included in inventory costs, are costs that are expected to generate future economic benefits to the enterprise. Such costs must be costs of acquisition and costs that change either (i) the location of the inventory, e.g. freight incurred to carry the materials to factory or (ii) conditions of the inventory, e.g. costs incurred to convert the materials into finished stock.

The costs incurred to maintain the inventory, e.g. storage costs, do not generate any extra economic benefits for the enterprise and therefore should not be included in inventory costs.

The valuation of inventory is crucial because of its direct impact in measuring profit/loss for an accounting period. Higher the value of closing inventory lower is the cost of goods sold and hence larger is the profit. The principle of prudence demands that no profit should be anticipated while all foreseeable losses should be recognised. Thus, if net realisable value of inventory is less than inventory cost, inventory is valued at net realisable value to reduce the reported profit in anticipation of loss. On the other hand, if net realisable value of inventory is more than inventory cost, the anticipated profit is ignored and the inventory is valued at cost. In short, inventory is valued at lower of cost and net realisable value. The standard specifies (i) what the cost of inventory should consist of and (ii) how the net realisable value is determined.

Failure of an item of inventory to recover its costs is unusual. If net realisable value of an item of inventory is less than its cost, the fall in profit in consequence of writing down of inventory to net realisable is an unusual loss and should be shown as a separate line item in the Profit & Loss statement to help the users of financial statements to make a more informed analysis of the enterprise performance.

By their very nature, abnormal gains or losses are not expected to recur regularly. For a meaningful analysis of an enterprise's performance, the users of financial statements need to

know the amount of such gains/losses included in current profit/loss. For this reason, instead of taking abnormal gains and losses in inventory costs, these are shown in the Profit and Loss statement in such way that their impact on current profit/loss can be perceived.

Part I of Schedule III to the Companies Act prescribes that valuation mode shall be disclosed for inventory held by companies. AS 2 "Valuation of Inventories" was first issued in June 1981 to supplement the legal requirements. It was revised and made mandatory for all enterprises in respect of accounting periods commencing on or after April 1, 1999.

Paragraph 3 of AS 2 defines inventories as assets held

- (a) For sale in the ordinary course of business or
- (b) In the process of production for such sale or
- (c) In the form of materials or supplies to be consumed in the production process or in rendering of services.

As per paragraph 1 of the Accounting Standards, following are excluded from the scope of AS 2.

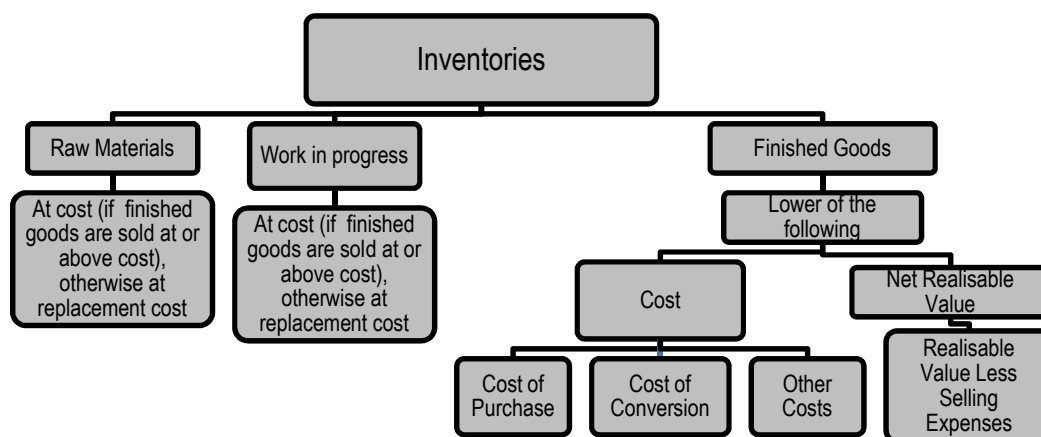
- (a) Work in progress arising under construction contracts, i.e. cost of part construction, including directly related service contracts, being covered under AS 7, Accounting for Construction Contracts; Inventory held for use in construction, e.g. cement lying at the site shall however be covered by AS 2.
- (b) Work in progress arising in the ordinary course of business of service providers i.e. cost of providing a part of service. For example, for a shipping company, fuel and stores not consumed at the end of accounting period is inventory but not costs for voyage-in-progress. Work-in-progress may arise for different other services e.g. software development, consultancy, medical services, merchant banking and so on.
- (c) Shares, debentures and other financial instruments held as stock-in-trade. It should be noted that these are excluded from the scope of AS 13 as well. The current Indian practice is however to value them at lower of cost and fair value.
- (d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries, e.g. where sale is assured under a forward contract or a government guarantee or where a homogenous market exists and there is negligible risk of failure to sell.

Containers and Empties

Containers and empties are neither goods for sale in the ordinary course of business, nor are they goods in the production process nor they are materials or supplies for consumption in the production process or in rendering of services. The Expert Advisory Committee of ICAI has however expressed an opinion that containers and empties are items of inventory. It seems nevertheless that containers and empties having useful life more than one year should be regarded as depreciable assets, in accordance with AS 6.

Measurement of Inventories

Inventories should be valued at lower of cost and net realisable value. As per paragraph 3, net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. The valuation of inventory at lower of cost and net realisable value is based on the view that no asset should be carried at a value which is in excess of the value realisable by its sale or use.



Example 1

Cost of a partly finished unit at the end of 2009-10 is ₹ 150. The unit can be finished next year by a further expenditure of ₹ 100. The finished unit can be sold at ₹ 250, subject to payment of 4% brokerage on selling price. The value of inventory is determined below:

	₹
Net selling price	250
Less: Estimated cost of completion	(100)
	150
Less: Brokerage (4% of 250)	(10)
Net Realisable Value	140
Cost of inventory	150
Value of inventory (Lower of cost and net realisable value)	140

Costs of inventory

Costs of inventories comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of purchase

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities, e.g. CENVAT credit, State level Value Added Tax etc, freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Example 2

An enterprise ordered 13,000 Kg. of certain material at ₹ 90 per unit. The purchase price includes excise duty ₹ 5 per Kg., in respect of which full CENVAT credit is admissible. Freight incurred amounted to ₹ 80,600. Normal transit loss is 4%. The enterprise actually received 12,400 Kg and consumed 10,000 Kg.

Cost of inventory and allocation of material cost is shown below:

(Normal cost per Kg.)

	₹
Purchase price (13,000 Kg. x ₹ 90)	11,70,000
Less: CENVAT Credit (13,000 Kg. x ₹ 5)	(65,000)
	11,05,000
Add: Freight	80,600
A. Total material cost	11,85,600
B. Number units normally received = 96% of 13,000 Kg.	Kg. 12,480
C. Normal cost per Kg. (A/B)	95

Allocation of material cost

	Kg.	₹ /Kg.	₹
Materials consumed	10,000	95	9,50,000
Cost of inventory	2,400	95	2,28,000
Abnormal loss	80	95	7,600
Total material cost	12,480	95	11,85,600

Note: Abnormal losses are recognised as separate expense.

Costs of Conversion

The costs of conversion include costs directly related to production, e.g. direct labour. They also include overheads, both fixed and variable. (Paragraph 8)

The fixed production overheads should be absorbed systematically to units of production over normal capacity. Normal capacity is the production the enterprise expects to achieve on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates the normal capacity. The amount of fixed production overheads allocated to each unit of production should not be increased as a consequence of low production or idle plant. Unallocated overheads (i.e. under recovery) are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

Example

ABC Ltd. has a plant with the capacity to produce 1 lac unit of a product per annum and the expected fixed overhead is ₹ 18 lacs. Fixed overhead on the basis of normal capacity is ₹ 18 (18 lacs/1 lac).

Case 1: *Actual production is 1 lac units. Fixed overhead on the basis of normal capacity and actual overhead will lead to same figure of ₹ 18 lacs. Therefore it is advisable to include this on normal capacity.*

Case 2: *Actual production is 90,000 units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is ₹ 20 (18 lacs/ 90 thousands). Hence by valuing inventory at ₹ 20 each for fixed overhead purpose, it will be overvalued and the losses of ₹ 1.8 lacs will also be included in closing inventory leading to a higher gross profit than actually earned. Therefore, it is advisable to include fixed overhead per unit on normal capacity to actual production (90,000 x 18) ₹ 16.2 lacs and rest ₹ 1.2 lacs shall be transferred to Profit & Loss Account.*

Case 3: *Actual production is 1.2 lacs units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is ₹ 15 (18 lacs/ 1.2 lacs). Hence by valuing inventory at ₹ 18 each for fixed overhead purpose, we will be adding the element of cost to inventory which actually has not been incurred. At ₹ 18 per unit, total fixed overhead comes to ₹ 21.6 lacs whereas, actual fixed overhead expense is only ₹ 18 lacs. Therefore, it is advisable to include fixed overhead on actual basis (1.2 lacs x 15) ₹ 18 lacs.*

Joint or By-Products

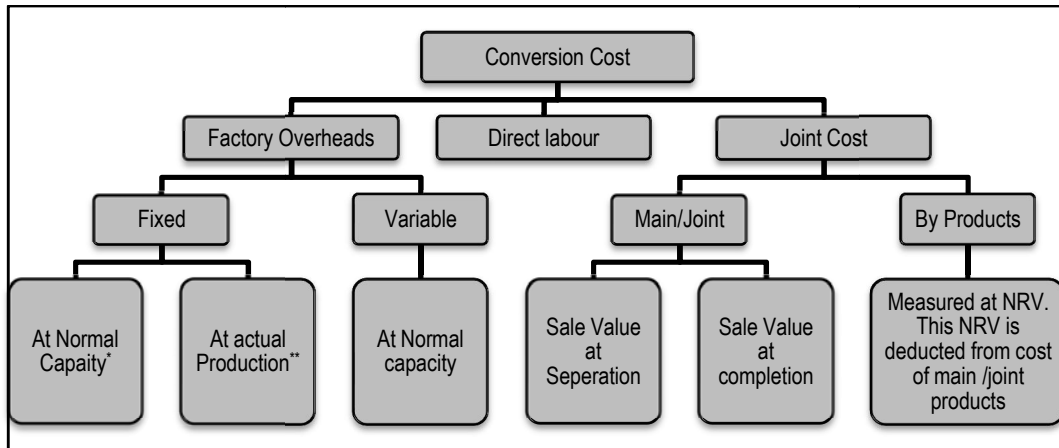
In case of joint or by products, the costs incurred up to the stage of split off should be allocated on a rational and consistent basis. The basis of allocation may be sale value at split off point, for example, value of by products, scraps and wastes are usually not material. These are therefore valued at net realisable value. The cost of main product is then valued as joint cost minus net realisable value of by-products, scraps or wastes.

Other Costs

- (a) These may be included in cost of inventory provided they are incurred to bring the inventory to their present location and condition. Cost of design, for example, for a custom made unit may be taken as part of inventory cost. (Paragraph 11)
- (b) Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition. These costs are therefore not usually included in cost of inventory (Paragraph 12). Interests and other borrowing costs however are taken as part of inventory costs, where the inventory necessarily takes substantial period of time for getting ready for intended sale. Example of such inventory is wine.
- (c) The standard is silent on treatment of amortisation of intangibles for ascertaining inventory costs. It nevertheless appears that amortisation of intangibles related to

production, e.g. patents right of production or copyright for a publisher should be taken as part of inventory costs.

- (d) Exchange differences are not taken in inventory costs.



*When actual production is almost equal or lower than normal capacity.

** When actual production is higher than normal capacity.

Exclusions from the cost of inventories

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

- (a) Abnormal amounts of wasted materials, labour, or other production costs;
- (b) Storage costs, unless the production process requires such storage;
- (c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition;
- (d) Selling and distribution costs.

Cost Formula

Mostly inventories are purchased / made in different lots and unit cost of each lot frequently differs. In all such circumstances, determination of closing inventory cost requires identification of units in stock to have come from a particular lot. This specific identification is best wherever possible. In all other cases, the cost of inventory should be determined by the First-In First-Out (FIFO), or Weighted Average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

Other techniques of cost measurement

- (a) Instead of actual, the standard costs may be taken as cost of inventory provided standards fairly approximate the actual. Such standards (for finished or partly finished units) should be set in the light of normal levels of material consumption, labour

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efficiency and capacity utilisation. The standards so set should be regularly reviewed and if necessary, be revised to reflect current conditions.

- (b) In retail business, where a large number of rapidly changing items are traded, the actual costs of items may be difficult to determine. The units dealt by a retailer however, are usually sold for similar gross margins and a retail method to determine cost in such retail trades makes use of the fact. By this method, cost of inventory is determined by reducing sale value of unsold stock by appropriate average percentage of gross margin.

Example 4

A trader purchased certain articles for ₹ 85,000. He sold some of articles for ₹ 1,05,000. The average percentage of gross margin is 25% on cost. Opening stock of inventory at cost was ₹ 15,000.

Cost of closing inventory is shown below:

	₹
Sale value of opening stock and purchase ($₹ 85,000 + ₹ 15,000$) $\times 1.25$	1,25,000
Sales	(1,05,000)
Sale value of unsold stock	20,000
Less: Gross Margin ($₹ 20,000 / 1.25$) $\times 0.25$	(4,000)
Cost of inventory	16,000

Estimates of Net Realisable Value

Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

Comparison of Cost and Net Realisable Value

The comparison between cost and net realisable value should be made on item-by-item basis. In some cases nevertheless, it may be appropriate to group similar or related items.

Example 5

The cost, net realisable value and inventory value of two items that a company has in its inventory are given below:

	Cost	Net Realisable Value	Inventory Value
	₹	₹	₹
Item 1	50,000	45,000	45,000
Item 2	20,000	24,000	20,000
Total	70,000	69,000	65,000

Estimates of NRV should be based on evidence available at the time of estimation.

As per paragraph 3 of the standard, net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Paragraph 22 also provides that estimates of net realisable value

are to be based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

NRV of materials held for use or disposal

Materials and other supplies held for use in the production of inventories are not written down below cost if the selling price of finished product containing the material exceeds the cost of the finished product. The reason is, as long as these conditions hold the material realises more than its cost as shown below.

Review of net realisable value at each balance sheet date

If an item of inventory remains at more than one balance sheet dates, paragraph 25 of AS 2 requires reassessment of net realisable value of the item at each balance sheet date. The standard is silent whether an item of inventory carried at net realisable value, can be written up on subsequent increase of net realisable value.

Disclosures

Paragraph 26 of AS 2 requires financial statements to disclose:

- (a) accounting policies adopted in measuring inventories, including the cost formula used
- (b) total carrying amount of inventories and its classification appropriate to the enterprise.

Paragraph 27 requires disclosure of carrying amounts and changes in them during an accounting period for each class of inventory, e.g. raw materials, components, work-in-progress, finished stock, stores, spares and loose tools.

2.4.3 Cash Flow Statement (AS 3)

Traditional financial statements comprised of a balance sheet portraying at the end of accounting period, resources controlled by the reporting enterprise together with sources of funds used for their acquisition and a statement of income, showing income, expenses and profit earned or loss incurred by the reporting enterprise during the accounting period. It was however noticed that due to use of accrual basis of accounting, recognition of financial elements, e.g. assets, liabilities, income, expenses and equity, coincide with the events to which they relate rather than with cash receipts or payments. For this reason, traditional financial statements fail to inform the users the way the reporting enterprise has generated cash and the way these were utilised during the accounting period. To a person, less accustomed with accounting practices, it may sometimes appear perplexing to observe that despite earning large profit, an enterprise is left with very little cash to pay dividends. The need for inclusion of a summary of cash receipts and payments in the financial statements of the reporting enterprise was therefore recognised. The summary of cash receipts and payments during an accounting period is called the Cash Flow Statement.

A simple example is given below to illustrate the relation of cash flow with profitability of an enterprise.

Status of AS 3

The standard is mandatory for Level 1 enterprises in respect of accounting periods commencing on or after April 1, 2001. The Level II and Level III non-corporate entities and Level II corporate entities are encouraged but not required to apply the standard.

Meaning of the term cash for cash flow statements

Cash for the purpose of cash flow statement consists of the following:

- (a) Cash in hand and deposits repayable on demand with any bank or other financial institutions and
- (b) Cash equivalents, which are short term, highly liquid investments that are readily convertible into known amounts of cash and are subject to insignificant risk or change in value. A short-term investment is one, which is due for maturity within three months from the date of acquisition. Investments in shares are not normally taken as cash equivalent, because of uncertainties associated with them as to realisable value.

Note : For the purpose of cash flow statement, 'cash' consists of at least three balance sheet items, viz. cash in hand; demand deposits with banks etc. and investments regarded as cash equivalents. For this reason, the paragraph 42 of the standard requires enterprises to give a break-up of opening and closing cash shown in their cash flow statements. This is presented as a note to cash flow statement.

Meaning of the term cash flow

Cash flows are inflows (i.e. receipts) and outflows (i.e. payments) of cash and cash equivalents. Any transaction, which does not result in cash flow, should not be reported in the cash flow statement. Movements within cash or cash equivalents are not cash flows because they do not change cash as defined by AS 3, which is sum of cash, bank and cash equivalents. For example, acquisitions of cash equivalent investments or cash deposited into bank are not cash flows.

It is important to note that a change in cash does not necessarily imply cash flow. *For example suppose an enterprise has a bank balance of USD 10,000, stated in books at ₹ 4,90,000 using the rate of exchange ₹ 49/USD prevailing on date of receipt of dollars. If the closing rate of exchange is ₹ 50/USD, the bank balance will be restated at ₹ 5,00,000 on the balance sheet date. The increase is however not a cash flow because neither there is any cash inflow nor there is any cash outflow.*

Types of cash flow

Cash flows for an enterprise occur in various ways, e.g. through operating income or expenses, by borrowing or repayment of borrowing or by acquisition or disposal of fixed assets. The implication of each type of cash flow is clearly different. Cash received on disposal of a useful fixed asset is likely to have adverse effect on future performance of the enterprise and it is completely different from cash received through operating income or cash received through borrowing. It may also be noted that implications cash flow types are interrelated. For example, borrowed cash used for meeting operating expenses is not same as borrowed cash used for acquisition of useful fixed assets.

For the aforesaid reasons, the standard identifies three types of cash flows, i.e. investing cash flows, financing cash flows and operating cash flows. Separate presentation of each type of cash flow in the cash flow statement improves usefulness of cash flow information.

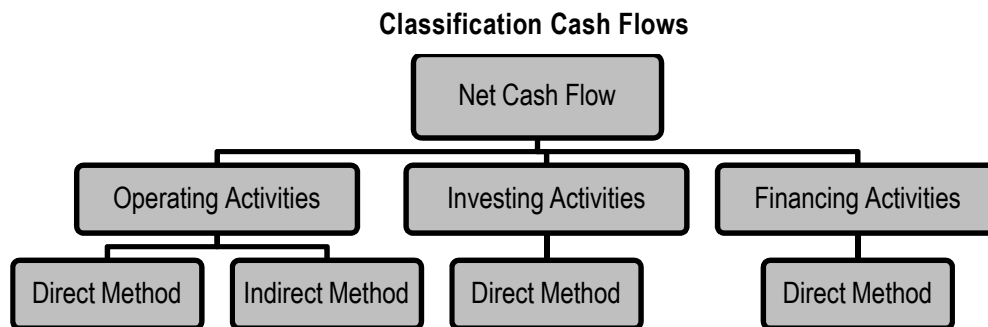
The investing cash flows are cash flows generated by investing activities. The investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The examples of investing cash flows include cash flow arising from investing activities include: (a) receipts from disposals of fixed assets; (b) loan given to / recovered from other entities (other than loans by financial enterprises) (c) payments to acquire fixed assets (d) Interests and dividends earned (other than interests and dividends earned by financial institutions).

The financing cash flows are cash flows generated by financing activities. Financing activities are activities that result in changes in the size and composition of the owners' capital (including preferences share capital in the case of company) and borrowings of the enterprise. Examples include issue of shares / debentures, redemption of debentures / preference shares, payment of dividends and payment of interests (other than interests paid by financial institutions).

The operating cash flows are cash flows generated by operating activities or by other activities that are not investing or financing activities. Operating activities are the principal revenue-producing activities of the enterprise. Examples include, cash purchase and sale of goods, collections from customers for goods, payment to suppliers of goods, payment of salaries, wages etc.

Identifying type of cash flows

Cash flow type depends on the business of the enterprise and other factors. For example, since principal business of financial enterprises consists of borrowing, lending and investing, loans given and interests earned are operating cash flows for financial enterprises and investing cash flows for other enterprises. A few typical cases are discussed below.



Loans/Advances given and Interests earned

- (a) Loans and advances given and interests earned on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Loans and advances given and interests earned on them are investing cash flows for non-financial enterprises.

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- (c) Loans and advances given to subsidiaries and interests earned on them are investing cash flows for all enterprises.
- (d) Loans and advances given to employees and interests earned on them are operating cash flows for all enterprises.
- (e) Advance payments to suppliers and interests earned on them are operating cash flows for all enterprises.
- (f) Interests earned from customers for late payments are operating cash flows for non-financial enterprises.

Loans/Advances taken and interests paid

- (a) Loans and advances taken and interests paid on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Loans and advances taken and interests paid on them are financing cash flows for non-financial enterprises.
- (c) Loans and advances taken from subsidiaries and interests paid on them are investing cash flows for all enterprises.
- (d) Advance taken from customers and interests paid on them are operating cash flows for non-financial enterprises.
- (e) Interests paid to suppliers for late payments are operating cash flows for all enterprises.
- (f) Interests taken as part of inventory costs in accordance with AS 16 are operating cash flows.

Investments made and dividends earned

- (a) Investments made and dividends earned on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Investments made and dividends earned on them are investing cash flows for non-financial enterprises.
- (c) Investments in subsidiaries and dividends earned on them are investing cash flows for all enterprises.

Dividends Paid

Dividends paid are financing cash outflows for all enterprises.

Income Tax

- (a) Tax paid on operating income is operating cash outflows for all enterprises
- (b) Tax deducted at source against income are operating cash outflows if concerned incomes are operating incomes and investing cash outflows if the concerned incomes are investment incomes, e.g. interest earned.

- (c) Tax deducted at source against expenses are operating cash inflows if concerned expenses are operating expenses and financing cash inflows if the concerned expenses are financing expenses, e.g. interests paid.

Insurance claims received

- (a) Insurance claims received against loss of stock or loss of profits are extraordinary operating cash inflows for all enterprises.
- (b) Insurance claims received against loss of fixed assets are extraordinary investing cash inflows for all enterprises.

Paragraph 28 of the standard requires separate disclosure of extraordinary cash flows, classifying them as cash flows from operating, investing or financing activities, as may be appropriate.

Profit or loss on disposal of fixed assets

Profit or loss on sale of fixed asset is not operating cash flow. The entire proceeds of such transactions should be taken as cash inflow from investing activity.

Fundamental techniques of cash flow preparation

A cash flow statement is a summary of cash receipts and payments of an enterprise during an accounting period. Any attempt to compile such a summary from cashbooks is impractical due to the large volume of transactions. Fortunately, it is possible to compile such a summary by comparing financial statements at the beginning and at the end of accounting period.

There are two methods, by which operating cash flows can be presented. By direct approach, the operating cash flows are presented under broad headings, e.g. cash received from customers and cash paid to suppliers and employees. By the indirect approach, operating cash flows are obtained by adjusting profits for changes in working capital and for non-cash charges, e.g. depreciation.

Reporting Cash Flows on Net Basis

Paragraph 21 of the standard forbids netting of receipts and payments from investing and financing activities. Thus, cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets. *For example, if an enterprise pays ₹ 50,000 in acquisition of machinery and realises ₹ 10,000 on disposal of furniture, it is not right to show net cash outflow of ₹ 40,000. The exceptions to this rule are stated in paragraphs 22 and 24.*

As per paragraph 22, cash flows from the following operating, investing or financing activities may be reported on a net basis.

- (a) Cash receipts and payments on behalf of customers, e.g. cash received and paid by a bank against acceptances and repayment of demand deposits.
- (b) Cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short, e.g. purchase and sale of investments by an investment company.

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Paragraph 24 permits financial enterprises to report cash flows on a net basis in the following three circumstances.

- (a) Cash flows on acceptance and repayment of fixed deposits
- (b) Cash flows on placement and withdrawal deposits from other financial enterprises
- (c) Cash flows on advances/loans given to customers and repayments received therefrom.

Non-Cash transactions

Investing and financing transactions that do not require the use of cash or cash equivalents, e.g. issue of bonus shares, should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Business Purchase

The aggregate cash flows arising from acquisitions and disposals of business units should be presented separately and classified as cash flow from investing activities. (Paragraph 37)

- (a) The cash flows from disposal and acquisition should not be netted off. (Paragraph 39)
- (b) As per paragraph 38, an enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:
 - (i) The total purchase or disposal consideration; and
 - (ii) The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

Treatment of current assets and liabilities taken over on business purchase

Business purchase is not operating activity. Thus, while taking the differences between closing and opening current assets and liabilities for computation of operating cash flows, the closing balances should be reduced by the values of current assets and liabilities taken over. This ensures that the differences reflect the increases/decreases in current assets and liabilities due to operating activities only.

Exchange gains and losses

The foreign currency monetary assets (e.g. balance with bank, debtors etc.) and liabilities (e.g. creditors) are initially recognised by translating them into reporting currency by the rate of exchange transaction date. On the balance sheet date, these are restated using the rate of exchange on the balance sheet date. The difference in values is exchange gain/loss. The exchange gains and losses are recognised in the statement of profit and loss (See AS 11 for details).

The exchange gains/losses in respect of cash and cash equivalents in foreign currency (e.g. balance in foreign currency bank account) are recognised by the principle aforesaid, and these balances are restated in the balance sheet in reporting currency at rate of exchange on balance sheet date. The change in cash or cash equivalents due to exchange gains and losses are however not cash flows. This being so, the net increases/decreases in cash or cash equivalents in

the cash flow statements are stated exclusive of exchange gains and losses. The resultant difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement.

Disclosures

Paragraph 45 of the standard requires an enterprise to disclose the amount of significant cash and cash equivalent balances held by it but not available for its use, together with a commentary by management. This may happen for example, in case of bank balances held in other countries subject to such exchange control or other regulations that the fund is practically of no use.

Paragraph 47 encourages disclosure of additional information, relevant for understanding the financial position and liquidity of the enterprise. Such information may include:

- (a) The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and
- (b) The aggregate amount of cash flows required for maintaining operating capacity, e.g. purchase of machinery to replace the old, separately from cash flows that represent increase in operating capacity, e.g. additional machinery purchased to increase production.

Example 1

Classify the following activities as (a) Operating Activities, (b) Investing Activities, (c) Financing Activities (d) Cash Equivalents.

- a. **Purchase of Machinery.**
- b. **Proceeds from issuance of equity share capital**
- c. **Cash Sales.**
- d. **Proceeds from long-term borrowings.**
- e. **Proceeds from Trade receivables.**
- f. **Cash receipts from Trade receivables.**
- g. **Trading Commission received.**
- h. **Purchase of investment.**
- i. **Redemption of Preference Shares.**
- j. **Cash Purchases.**
- k. **Proceeds from sale of investment**
- l. **Purchase of goodwill.**
- m. **Cash paid to suppliers.**
- n. **Interim Dividend paid on equity shares.**
- o. **Wages and salaries paid.**

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- p. Proceed from sale of patents.*
- q. Interest received on debentures held as investment.*
- r. Interest paid on Long-term borrowings.*
- s. Office and Administration Expenses paid*
- t. Manufacturing Overheads paid.*
- u. Dividend received on shares held as investments.*
- v. Rent Received on property held as investment.*
- w. Selling and distribution expense paid.*
- x. Income tax paid*
- y. Dividend paid on Preference shares.*
- z. Underwritings Commission paid.*
- aa. Rent paid.*
- bb. Brokerage paid on purchase of investments.*
- cc. Bank Overdraft*
- dd. Cash Credit*
- ee. Short-term Deposits*
- ff. Marketable Securities*
- gg. Refund of Income Tax received.*

Solution

- (a) Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.*
- (b) Investing Activities: a, h, k, l, p, q, u, v, bb & ee.*
- (c) Financing Activities: b, d, i, n, r, y, z, cc & dd.*
- (d) Cash Equivalent: ff.*

Note: For details regarding preparation of Cash Flow Statement and Problems based on practical application of AS 3, students are advised to refer unit 2 of Chapter 2.

2.4.4 Depreciation Accounting (AS 6)

Where an asset, e.g. machinery, generates revenue over more than one accounting period, the matching principle demands that the cost of the asset be recognised over same number of accounting periods. Also, the allocation, as far as possible should be in the proportion of revenue generated by the asset. Depreciation for an accounting period is the cost of assets allocated to that accounting period. However, the allocated historical cost of an asset may not always reflect the appropriate charge against revenue. This can happen for example, when the asset has a terminal value or when the asset is revalued. For this reason, depreciation for

an accounting period is regarded as amount of depreciable value allocated to an accounting period. The depreciable value is historical cost \pm Change in historical cost due to revaluation or otherwise – terminal value expected on disposal of the asset.

The depreciation is a non-cash charge, i.e. a charge of depreciation reduces profit available for distribution without reducing the available cash. The cash thus retained in the business is intended to be used for replacement of the depreciable asset. For this reason, section 128 of the Companies Act 2013, provides that companies can pay dividend only out of profit available after charging depreciation in accordance with subsection 2 of that section. For the purpose, Schedule II of the Companies Act prescribes about rates of depreciation.

Accounting standard 6, sets the broad principles for computation of depreciation without prescribing any specific rate or method of depreciation. Enterprises other than companies to which the standard applies, must compute and charge depreciation in accordance with the standard. In case of companies, the depreciation charged should be higher of (i) depreciation under Companies Act (ii) depreciation as per AS 6.

AS 6 is mandatory in respect of accounting periods commencing on or after April 1, 1995. It applies to all enterprises.

Land has indefinite life and hence does not permit allocation of value over finite number of accounting periods. Hence, the standard does not apply to land, unless it has a limited useful life. The standard applies to all depreciable assets except the following to which special considerations apply:

- (i) forests, plantations and similar regenerative natural resources
- (ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources
- (iii) expenditure on research and development
- (iv) livestock

Accounting Standard 6 defines depreciation as a measure of the wearing out, consumption or other loss of value of depreciable asset arising from use, efflux of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is pre-determined.

"Depreciable assets" are assets which:

1. are expected to be used during more than one accounting period; and
2. have a limited useful life; and
3. are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

"Useful life" is either

- (a) the period over which a depreciable asset is expected be used by the enterprise; or

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- (b) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

"Depreciable amount" of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less estimated residual value.

The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

The useful life of a depreciable asset should be estimated after considering:

- (i) expected physical wear and tear
- (ii) obsolescence and
- (iii) legal or other limits on the use of the asset.

The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life. (Paragraph 23)

Amount of Depreciation

The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

Methods of Depreciation

There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method. The management of a business selects the most appropriate method(s). A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired, e.g. books.

- (a) **Straight Line Method:** *An equal amount is written off every year during the working life on an asset so as to reduce the cost of the asset to NIL or to its residual value at the end of its useful life.*

$$\text{Straight Line Depreciation} = \frac{\text{Cost of Asset} - \text{Scrap Value}}{\text{Useful Life}}$$

$$\text{Depreciation Rate} = \frac{\text{Straight Line Depreciation} \times 100}{\text{Cost of Asset}}$$

This method of charging depreciation is recommended mostly for power generating units or for the assets where danger of obsolescence is low.

- (b) **Reducing Balance/Written Down Value Method:** A fixed percentage of the diminishing value of the asset is written off each year so as to reduce the asset to its salvage value at the end of its life.

$$\text{Depreciation Rate} = 1 - \sqrt[n]{\frac{\text{Residual Value}}{\text{Cost of Asset}}} \times 100$$

n = useful life.

This method is highly recommended mainly for manufacturing units though it is recommended for most of the enterprises.

Distinction between Straight Line and Written Down Value Method:

	Straight Line Method	Written Down Value
1.	Amount of depreciation is calculated at a fixed percentage on the original cost of the fixed asset.	Amount of depreciation is calculated at a fixed percentage on written down value of the fixed amount.
2.	Amount of depreciation remains same year to year.	Amount of depreciation decreases year to year.
3.	At the end of the life, the value of asset can be zero.	The value of assets never comes to zero.
4.	It is also known as Fixed Instalment Method or Constant Charge Method.	It is also known as Reducing or Diminishing Balance Method.
5.	It is easy to calculate.	It is difficult to calculate.
6.	Depreciation + Repair keep increasing.	Depreciation + Repairs more or less remains constant.
7.	Suitable for the assets that requires fewer repairs.	Suitable for assets, which requires more repairs with passage of time.

- (c) **Sum of the Year Digit Method (SYD):** Under this method, the rate of depreciation is charged on the original cost. However, the rate of depreciation for each year is a fraction in which the denominator is the sum of the year digits from 1 to n and numerator for the first year is n , for the second year $n-1$, for the third year $n-2$ and so on.

$$\text{Rate of Depreciation for each year is} = \frac{n - (x - 1)}{n(n + 1) / 2}$$

Where, n = useful life of the asset.

x = number of years asset is in use.

- (d) **Machine Hour Method:** Where it is practically possible to keep a record of the actual running hours of each machine, depreciation may be calculated on the basis of hours that the concerned machine worked.

$$\text{Depreciation for year 'n'} = \frac{\text{Hours worked in n} \times (\text{Cost} - \text{Salvage Value})}{\text{Total Estimated Working Hours}}$$

This method is recommended for the assets mainly machinery, where in the cost of the asset was determined mainly based on the useful working hours of the machine.

- (e) **Depletion Method:** *This method is used in case of mines, quarries etc. containing only a certain quantity of product. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available.*

$$\text{Depreciation for year 'n'} = \frac{\text{Qty. Extracted / Produced in 'n'} \times (\text{Cost} - \text{Residual Value})}{\text{Total Estimated Quantity}}$$

- (f) **Annuity Method:** *This is a method of depreciation which also takes into account the element of interest on capital outlay and seeks to write off the value of the asset as well as the interest lost over the life of the asset. On that basis, the amount of depreciation to be annually provided in the account is ascertained from the Annuity Tables. Though the amount written off annually is constant, the interest in the earlier years being greater, only small amount of the capital outlay is written off. This proportion is reversed with the passage of time.*

This method of charging depreciation is mostly recommended for leasehold assets.

- (g) **Sinking Fund Method:** *If the sum involved in replacing the asset is large, than just providing for depreciation will not be sufficient, as because the concern may not have the ready fund available to replace the assets. For this purpose a Sinking Fund Account is created, a depreciation amount is credited to it. The amount is invested in some Government Securities. Every year the process is repeated, interest received from such securities is also reinvested and these securities are sold at the end of the life of the asset, so that the concern has the ready fund to replace the asset.*

Example 1

A machine of cost 1,20,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. The estimate of remaining useful life after third year was reassessed at 5 years.

Depreciation per year charged for three years = ₹ 1,20,000 / 10 = ₹ 12,000

WDV of the machine at the end of third year = ₹ 1,20,000 – ₹ 12,000 × 3 = ₹ 84,000.

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 5 years

Depreciation for the fourth year onwards = ₹ 84,000 / 5 = ₹ 16,800.

Additions and Extensions

- (a) Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed off, depreciation should be provided independently on the basis of an estimate of its own useful life.
- (b) Where an addition or extension becomes an integral part of an existing asset, it should be depreciated over the asset's remaining useful life. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset.

Example 2

The estimated working life of a machine is 6 years. The machine is used with an attachment having a useful life of 10 years. The cost of the machine and that of the attachment are ₹ 60,000 and ₹ 6,000 respectively. The terminal value is zero for both. Straight-line depreciation is in use.

Depreciation for the year:

- (a) *if the attachment retains a separate identity and is capable of being used after the machine is disposed off = ₹ 60,000 / 6 + ₹ 6,000 / 10 = ₹ 10,600*
- (b) *if the attachment becomes an integral part of the machine = ₹ 66,000 / 6 = ₹ 11,000*

Change in Depreciable Amount

- (a) The historical cost of a depreciable asset may change due to increase or decrease in long-term liability on account of exchange fluctuations (See note), price adjustments, changes in duties or other similar factors. In these cases, depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual life of the asset.
- (b) Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.

The aforesaid two requirements ensure that no amortisation of depreciable amounts remain pending after the assets cease to be useful. Since an asset does not generate any revenue after its useful life is over, any amortisation charged against revenue after such time, defeats the principle of matching revenue and costs.

Example 3

A machine of cost 1,20,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. At the end of third year, the machine was revalued upwards by ₹ 6,000 the remaining useful life was reassessed at 9 years.

Depreciation per year charged for three years = ₹ 1,20,000 / 10 = ₹ 12,000

WDV of the machine at the end of third year = ₹ 1,20,000 – ₹ 12,000 × 3 = ₹ 84,000.

Depreciable amount after revaluation = ₹ 84,000 + ₹ 6,000 = ₹ 90,000

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 9 years

Depreciation for the fourth year onwards = ₹ 90,000 / 9 = ₹ 10,000.

Change in Method of Charging Depreciation

The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use.

The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

Example 4

A company acquired a machine on 01/04/11 for ₹ 5,00,000. The company charged straight-line depreciation based on 10 year working life estimate and residual value ₹ 50,000 upto 2013-14. From 2014-15, the company decided to change to 20% reducing balance method of depreciation. Show adjustment required in books of the company.

Solution

Annual depreciation charged by the company upto 2013-14

$$= (\text{₹ } 5,00,000 - \text{₹ } 50,000) / 10 = \text{₹ } 45,000$$

$$\text{WDV of machine at the end of 2011-12} = \text{₹ } 5,00,000 - \text{₹ } 45,000 \times 3 = \text{₹ } 3,65,000$$

WDV of machine at the end 2013-14 (by reducing balance method)

$$= \text{₹ } 5,00,000 (1 - 0.20)^3 = \text{₹ } 2,56,000$$

Depreciation to be charged in 2014-15

$$= (\text{₹ } 3,65,000 - \text{₹ } 2,56,000) + 20\% \text{ of } \text{₹ } 2,56,000 = \text{₹ } 1,60,200$$

Books of the company

	₹ 000	₹ 000
Depreciation	160.2	
To Machine		160.2
Profit & Loss A/c	160.2	
To Depreciation		160.2

Machine A/c

	₹ 000		₹ 000
To Balance b/d	365.0	By Depreciation	160.2
		By Balance c/d	204.8
	365.0		365.0

Example 5

Mr. A purchased a machine on 01.04.2009 for ₹ 1,00,000. On 01.07.2010 he purchased another machine for ₹ 1,50,000. On 01.10.2011, he purchased the third machine for ₹ 2,00,000 and on 31.12.2012 he sold the second machine for ₹ 1,25,000. On 31.03.2014 he decided to change the method of charging depreciation from Straight Line Method @ 10% p.a. to Written Down Value Method @ 15%. Show Machine Account from 1.4.2009 to 31.3.2014.

Solution**Working Note 1: Depreciation charged under old method:**

Particulars	₹	₹
Purchase of first machine	1,00,000	
Depreciation for 4 years (1,00,000 x 10% x 4)		40,000
Purchase of third machine	2,00,000	
Depreciation for 1.5 years (2,00,000 x 10% x 1.5)		30,000
Total Depreciation charged		70,000

Working Note 2: Depreciation to be charged under new method:

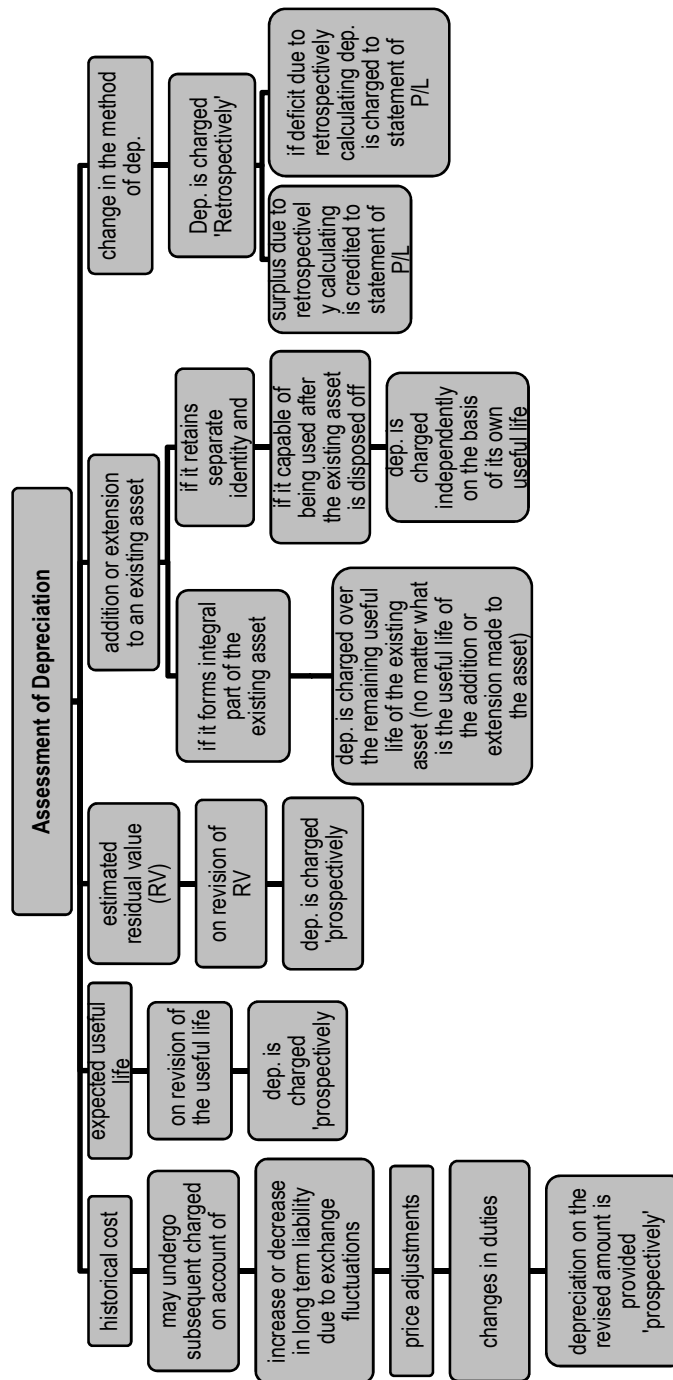
Year	Opening WDV ₹	Purchases ₹	Balance ₹	Depreciation ₹	Closing WDV ₹
2009-10	---	1,00,000	1,00,000	15,000	85,000
2010-11	85,000	---	85,000	12,750	72,250
2011-12	72,250	2,00,000	2,72,250	40,838	2,31,412
2012-13	2,31,412	---	2,31,412	34,712	1,96,700
		Total Depreciation		<u>1,03,300</u>	

Machine Account

Date	Particulars	₹	Date	Particulars	₹
01.04.2009	To Bank	1,00,000	31.03.2010	By Depreciation	10,000
				By Balance c/d	90,000
		1,00,000			1,00,000
01.04.2010	To Balance b/d	90,000	31.03.2011	By Depreciation	21,250

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01.07.2010	To Bank	1,50,000		By Balance c/d	2,18,750
		2,40,000			2,40,000
01.04.2011	To Balance b/d	2,18,750	31.03.2012	By Depreciation	35,000
01.10.2011	To Bank	2,00,000		By Balance c/d	3,83,750
		4,18,750			4,18,750
01.04.2012	To Balance b/d	383,750	31.12.2012	By Bank	125,000
31.12.2012	To Profit on Sale	12,500	31.03.2013	By Depreciation	41,250
		3,96,250		By Balance c/d	2,30,000
					3,96,250
01.04.2013	To Balance b/d	2,30,000	31.03.2014	By Profit & Loss A/c.	33,300
				By Depreciation (1,96,700 x 15%)	29,505
				By Balance c/d	1,67,195
		2,30,000			2,30,000
01.04.2014	To Balance b/d	1,67,195			



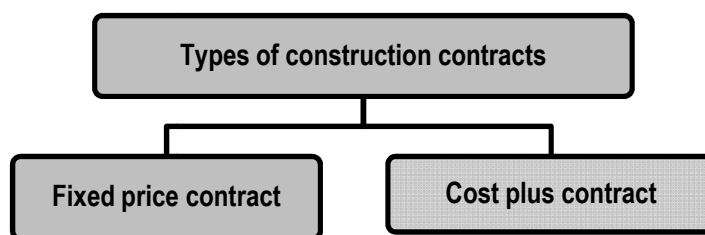
Disclosures

- (a) The following information should be disclosed in the financial statements:
- ◆ The historical cost or other amount substituted for historical cost of each class of depreciable assets;
 - ◆ Total depreciation for the period for each class of assets and the related accumulated depreciation.
- (b) In addition to above, the following information should be disclosed in the financial statements along with the disclosure of other accounting policies:
- ◆ depreciation methods used; and
 - ◆ depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.
- (c) If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

2.4.5 Construction Contracts (AS 7)

Accounting Standard 7 prescribes the principles of accounting for construction contracts in the financial statements of contractors. The focus of the standard is on principles of revenue recognition by the contractors. The standard was initially issued in December 1983 and had the title "Accounting for Construction Contracts". The standard was revised later and the revised standard applies to all enterprises in respect of construction contracts entered into during accounting periods commencing on or after April 1, 2003.

A construction contract is one, by which a contractor agrees to build some asset for his customer. The contractor's profit is the excess of contract price over construction costs. The contract price may or may not be fixed.



In a **fixed price contract**, the price is agreed as fixed sum. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations.

In a **cost plus contract**, the customer undertakes to reimburse specified costs together with a fee calculated as percentage on reimbursable costs. The fee is the contractor's margin of profit.

Percentage completion method

Construction contracts are mostly long term, i.e. they take more than one accounting year to complete. This means, the final outcome (profit/ loss) of a construction contract can be determined only after a number of years from the year of commencement of construction are over. It is nevertheless possible to recognise revenue annually in proportion of progress of work to be matched with corresponding construction costs incurred in that year. This method of accounting, called the percentage completion method, provides useful information on the extent of contract activity and performance during an accounting period.

The percentage completion method suffers from a serious drawback viz. anticipation of profit. Since the method recognises revenue pending final outcome of a contract is known, it is possible that an enterprise may distribute dividend based on reported profit of a year, while final result is loss. To avoid such possibilities, percentage completion method should be used with caution. The AS 7 prescribes that the percentage completion method should not be used unless it is possible to make a reasonable estimate of the final outcome of the contract. Also, paragraph 35 of the standard provides that whenever total contract cost is expected to exceed the total contract revenue, the loss should be recognised as an expense immediately.

As per paragraph 22, the outcome of fixed price contracts can be estimated reliably **when all the following conditions are satisfied:**

- (i) total contract revenue can be measured reliably;
- (ii) it is probable that the economic benefits associated with the contract will flow to the enterprise;
- (iii) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
- (iv) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

As per paragraph 23, the outcome of a cost plus contract can be estimated reliably when all the following conditions are satisfied:

- (i) it is probable that the economic benefits associated with the contract will flow to the enterprise; and
- (ii) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

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Example 1 (The percentage completion method)

X Ltd. commenced a construction contract on 01/04/13. The fixed contract price agreed was ₹ 2,00,000. The company incurred ₹ 81,000 in 2013-14 for 45% work and received ₹ 79,000 as progress payment from the customer. The cost incurred in 2014-15 was ₹ 89,000 to complete the rest of work.

Solution:

Profit & Loss Account

Year		₹ 000	Year		₹ 000
2013-14	To Construction Costs (for 45% work)	81	2013-14	By Contract Price (45% of Contract Price)	90
	To Net profit (for 45% work)	9			
		90			90
2014-15	To Construction costs (for 55% work)	89	2014-15	By Contract Price (55% of Contract Price)	110
	To Net Profit (for 55% work)	21			
		110			110

Customer Account

Year		₹ 000	Year		₹ 000
2013-14	To Contract Price	90	2013-14	By Bank	79
				By Balance c/d	11
		90			90
2014-15	To Balance b/d	11	2014-15	By Bank	121
	To Contract Price	110			
		121			121

The amount of contract revenue recognised in the statement of profit and loss as per the requirements of AS 7 should be considered as turnover. This means, the revenue recognised by percentage completion method should not be described as work-in progress. It may also be noted that as per the scheme for applicability of accounting standards, enterprises having turnover exceeding ₹ 50 crores treated as level I enterprises. The proportionate revenue recognised in the statement of profit and loss by a contractor, should be taken in computation of turnover for the purpose of the scheme. This is important because level I enterprises are required to comply with all applicable accounting standards in entirety.

The paragraph 31 provides that the percentage completion method should not be applied if the outcome of a construction contract cannot be estimated reliably. In such cases:

- (a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and
- (b) contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should however be recognised as an expense immediately.

When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method. (Para 34)

Example 2

X Ltd. commenced a construction contract on 01/04/13. The contract price agreed was reimbursable cost plus 20%. The company incurred ₹ 1,00,000 in 2013-14, of which ₹ 90,000 is reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at ₹ 5,000. The other costs to complete the contract could not be estimated reliably.

The Profit & Loss A/c extract of X Ltd. for 2013-14 is shown below:

Profit & Loss Account

	₹ 000		₹ 000
To Construction Costs	100	By Contract Price	90
To Provision for loss	5	By Net loss	15
	105		105

Treatment of costs relating to future activity (Para 26)

Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. The contract costs that relate to future activity on the contract are however recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

Uncollectable Contract Revenue (Para 27)

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

Stage of Completion (Para 29)

The stage of completion of a contract may be determined in a variety of ways. Depending on the nature of the contract, the methods may include:

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- (a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
- (b) surveys of work performed; or
- (c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

Example 3

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data.

	₹ 000
Contract price (Fixed)	600
Cost incurred to date	390
Estimated cost to complete	260

Solution

	₹ 000
A. Cost incurred to date	390
B. Estimate of cost to completion	<u>260</u>
C. Estimated total cost	<u>650</u>
D. Degree of completion (A/C)	60%
E. Revenue Recognized (60% of 600)	360
Total foreseeable loss (650 – 600)	50
Less: Loss for current year (E – A)	<u>(30)</u>
Expected loss to be recognised immediately	<u>20</u>

Profit & Loss A/c

	₹		₹
To Construction costs	390	By Contract Price	360
To Provision for loss	20	By Net Loss	50
	410		410

Combining and Segmenting Construction Contracts

A contractor may undertake a number of contracts. The percentage completion method may not however be appropriate in all cases. Each of the contracts should be tested on the basis of respective facts for electing the appropriate method of revenue recognition. The standard identifies certain cases where for the purposes of accounting, (i) More than one contract can

be taken as one and (ii) a single contract can be taken as to comprise of more than one contract.

- (a) When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:
 - (i) separate proposals have been submitted for each asset;
 - (ii) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
 - (iii) the costs and revenues of each asset can be identified.
- (b) A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:
 - (i) the group of contracts is negotiated as a single package;
 - (ii) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
 - (iii) the contracts are performed concurrently or in a continuous sequence.
- (c) A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. As per paragraph 9, the construction of the additional asset should be treated as a separate construction contract when:
 - (i) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
 - (ii) the price of the asset is negotiated without regard to the original contract price.

Example 4

Mr. Shyam, a construction contractor undertakes the construction of an industrial complex. He has separate proposals raised for each unit to be constructed in the industrial complex. Since each unit is subject to separate negotiation, he is able to identify the costs and revenues attributable to each unit. Should Mr. Shyam treat construction of each unit as a separate construction contract according to AS 7?

Solution

As per AS 7 'Construction Contracts', when a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

- (a) separate proposals have been submitted for each asset;*
- (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and*
- (c) the costs and revenues of each asset can be identified.*

Therefore, Mr. Shyam is required to treat construction of each unit as a separate construction contract.

Contract Revenue and costs

- (a) As per paragraph 10, contract revenue should comprise:
 - (i) the initial amount of revenue agreed in the contract; and
 - (ii) variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.
- (b) As per paragraph 15, contract costs should comprise:
 - (i) costs that relate directly to the specific contract;
 - (ii) costs that are attributable to contract activity in general and can be allocated to the contract; and
 - (iii) such other costs as are specifically chargeable to the customer under the terms of the contract.

Note:

- 1. Direct costs can be reduced by incidental income, e.g. sale of surplus material, not included in contract revenue. (Paragraph 16)
- 2. The allocation of indirect costs should be based on normal levels of construction activity. The allocable costs may include borrowing costs as per AS 16. (Paragraph 17)

Changes in Estimates (Para 37)

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate in accordance with AS 5. The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

Disclosure

- (a) The paragraph 38 requires an enterprise to disclose:
 - (i) the amount of contract revenue recognised as revenue in the period;
 - (ii) the methods used to determine the contract revenue recognised in the period; and
 - (iii) the methods used to determine the stage of completion of contracts in progress.
- (b) The paragraph 39 requires the following disclosures in respect of contracts in progress at the reporting date:

- (c) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
 - (i) the amount of advances received; and
 - (ii) the amount of retentions.
- (d) The Paragraph 41 requires an enterprise to present:
 - (i) the gross amount due from customers for contract work as an asset; and
 - (ii) the gross amount due to customers for contract work as a liability.

2.4.6 Revenue Recognition (AS 9)

This Standard is mandatory for all enterprises.

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:

- i. Revenue arising from construction contracts;
- ii. Revenue arising from hire-purchase, lease agreements;
- iii. Revenue arising from government grants and other similar subsidies;
- iv. Revenue of insurance companies arising from insurance contracts.

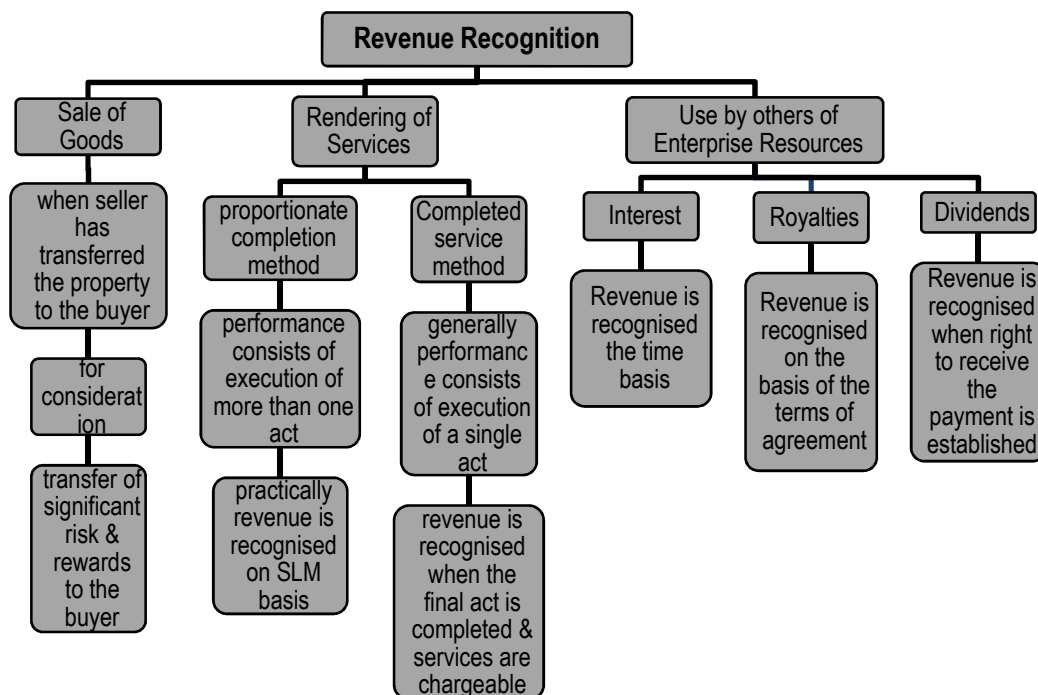
Examples of items not included within the definition of “revenue” for the purpose of this Statement are:

- i. Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;
- ii. Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
- iii. Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
- iv. Realised gains resulting from the discharge of an obligation at less than its carrying amount;
- v. Unrealised gains resulting from the restatement of the carrying amount of an obligation.

Sale of Goods

A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer.

At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit and loss and appropriately described.



Example 1

The stages of production and sale of a producer are as follow:

Date	Activity	Costs to date ₹	Net Realisable Value ₹
20.1.12	Raw Materials	10,000	8,000
25.1.12	WIP 1	12,000	13,000
27.1.12	WIP 2	15,000	19,000
25.2.12	Finished Product	17,000	30,000
12.3.12	Ready for Sale	17,000	30,000
27.3.12	Sale Agreed and invoice raised	19,000	30,000
02.4.12	Delivered and paid for	19,000	30,000

Explain the stage on which you think revenue will be recognized and state how much would be net profit on a unit of this product according to AS 9?

Solution

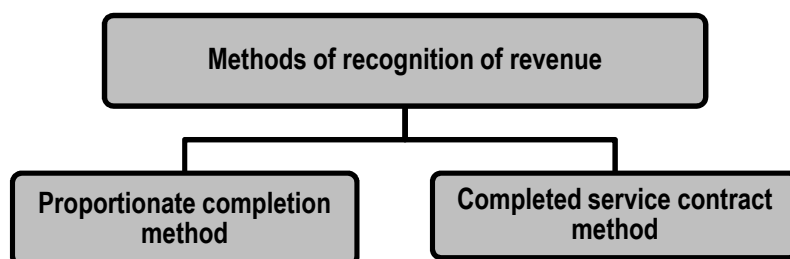
According to AS 9, sales will be recognized only when following two conditions are satisfied:

- (i) The sale value is fixed and determinable.
- (ii) Property of the goods is transferred to the customer.

Both these conditions are satisfied only on 27.3.2012 when sales are agreed upon at a price and goods are allocated for delivery purpose. The amount of net profit ₹ 11,000 (30,000 – 19,000) would be recognized in the books for the year ending 31st March, 2012.

Rendering of Services

Revenue from service transactions is usually recognised as the service is performed. There are two methods of recognition of revenue from service transaction, viz,



Proportionate completion method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services

under a contract. Here performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act.

Completed service contract method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable

Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

Use by others of such enterprise resources gives rise to:

- i. Interest: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognized on a time proportion basis taking into account the amount outstanding and the rate applicable.
- ii. Royalties: charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement.
- iii. Dividends: rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established.

Effect of Uncertainties on Revenue Recognition

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases:

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

Disclosure

An enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

2.4.7 Accounting For Fixed Assets (AS 10)

After introduction of AS 16, AS 19 & AS 26, provisions relating to respective AS are held withdrawn and the rest is mandatory from the accounting year 1-4-2000.

This statement does not deal with accounting for the following items to which special considerations apply:

- i. Forests, plantations and similar regenerative natural resources.
- ii. Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.
- iii. Expenditure on real estate development and
- iv. Livestock.

Identification of Fixed Assets

Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

Components of Cost

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price.

The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement.

Self-constructed Fixed Assets

Included in the gross book value are costs of construction that relate directly to the specific asset and cost that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.

Example 1

ABC Ltd. is constructing a fixed asset. Following are the expenses incurred on the construction:

<i>Materials</i>	₹ 10,00,000
<i>Direct Expenses</i>	₹ 2,50,000
<i>Total Direct Labour</i>	₹ 5,00,000
<i>(1/10th of the total labour time was chargeable to the construction)</i>	
<i>Total office & administrative expenses</i>	₹ 8,00,000
<i>(5% is chargeable to the construction)</i>	
<i>Depreciation on the assets used for the construction of this assets</i>	₹ 10,000
<i>Calculate the cost of fixed assets.</i>	

Solution**Calculation of the cost of construction of Assets**

<i>Particulars</i>	₹
<i>Direct Materials</i>	10,00,000
<i>Direct Labour</i>	50,000
<i>Direct Expenses</i>	2,50,000
<i>Office & Administrative Expenses</i>	40,000
<i>Depreciation</i>	10,000
<i>Cost of the Asset</i>	<u>13,50,000</u>

Non-monetary Consideration

When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident.

When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

Improvements and Repairs

Any expenditure that increase the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.

The cost of an addition or extension to an existing asset, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately.

Amount Substituted for Historical Cost

The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation.

Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis.

It is not appropriate for the revaluation of a class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class.

An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve.

Retirements and Disposals

Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognised immediately in the profit and loss statement.

On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

Hire Purchases

In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which, if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

Joint Ownership

Where an enterprise owns fixed assets jointly with others, the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

Goodwill

Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

Disclosure

- i. Gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;
- ii. Expenditure incurred on account of fixed assets in the course of construction or acquisition; and
- iii. Revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

Example 2

On March 01, 2013, X Ltd. purchased ₹ 5 lakhs worth of land for a factory site. Company demolished an old building on the property and sold the material for ₹ 10,000. Company incurred additional cost and realized salvaged proceeds during the March 2013 as follows:

<i>Legal fees for purchase contract and recording ownership</i>	<i>₹ 25,000</i>
<i>Title guarantee insurance</i>	<i>₹ 10,000</i>
<i>Cost for demolition of building</i>	<i>₹ 50,000</i>

In March 31, 2013 balance sheet, X Ltd. should report a balance in the land account.

Solution**Calculation of the cost for Purchase of Land**

Particulars		₹
Cost of Land		5,00,000
Legal Fees		25,000
Title Insurance		10,000
Cost of Demolition	50,000	
Less: Salvage value of Material	<u>(10,000)</u>	<u>40,000</u>
Cost of the Asset		575,000

2.4.8 Accounting for Investments (AS 13)

This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995.

This Statement does not deal with:

- The bases for recognition of interest, dividends and rentals earned on investments which are covered by AS 9.
- Operating or finance leases.
- Investments of retirement benefit plans and life insurance enterprises and
- Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 2013.

Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

Market value is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

Forms of Investments

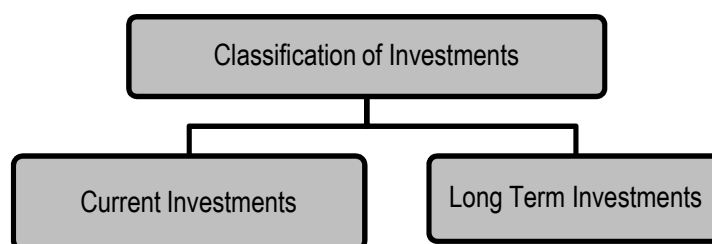
Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'.

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings).

For some investments, an active market exists from which a market value can be established. For other investments, an active market does not exist and other means are used to determine fair value.

Classification of Investments



A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

A long term investment is an investment other than a current investment.

Cost of Investments

The cost of an investment includes acquisition charges such as brokerage, fees and duties.

If an investment is acquired, or partly acquired, by the issue of shares or other securities or another asset, the acquisition cost is the fair value of the securities issued or assets given up. The fair value may not necessarily be equal to the nominal or par value of the securities issued. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income.

If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

Carrying Amount of Investments

The carrying amount for current investments is the lower of cost and fair value. Valuation of current investments on overall basis is not considered appropriate. The more prudent and appropriate method is to carry investments individually at the lower of cost and fair value. Any reduction to fair value and any reversals of such reductions are included in the Profit & Loss Statement.

Long-term investments are usually carried at cost. Where there is a decline, other than temporary, in the carrying amounts of long term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

Investment Properties

An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

Disposal of Investments

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

Reclassification of Investments

Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

Disclosure

The following disclosures in financial statements in relation to investments are appropriate: -

- a. The accounting policies for the determination of carrying amount of investments.
- b. The amounts included in profit and loss statement for:
 - i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.

- ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.
- iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.
- c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.
- d. The aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments.
- e. Other disclosures as specifically required by the relevant statute governing the enterprise.

Example 1

X Ltd. on 1-1-2014 had made an investment of ₹ 600 lakhs in the equity shares of Y Ltd. of which 50% is made in the long term category and the rest as temporary investment. The realizable value of all such investment on 31-3-2014 became ₹ 200 lakhs as Y Ltd. lost a case of copyright. From the given market conditions, it is apparent that the reduction in the value is permanent in nature. How will you recognize the reduction in financial statements for the year ended on 31-3-2014?

Solution

X Ltd. invested ₹ 600 lakhs in the equity shares of Y Ltd. Out of the same, the company intends to hold 50% shares for long term period i.e. ₹ 300 lakhs and remaining as temporary (current) investment i.e. ₹ 300 lakhs. Irrespective of the fact that investment has been held by X Ltd. only for 3 months (from 1.1.2014 to 31.3.2014), AS 13 lays emphasis on intention of the investor to classify the investment as current or long term even though the long term investment may be readily marketable.

In the given situation, the realizable value of all such investments on 31.3.2014 became ₹ 200 lakhs i.e. ₹ 100 lakhs in respect of current investment and ₹ 100 lakhs in respect of long term investment.

As per AS 13, 'Accounting for Investment', the carrying amount for current investments is the lower of cost and fair value. In respect of current investments for which an active market exists, market value generally provides the best evidence of fair value.

Accordingly, the carrying value of investment held as temporary investment should be shown at realizable value i.e. at ₹ 100 lakhs. The reduction of ₹ 200 lakhs in the carrying value of current investment will be charged to the profit and loss account.

Standard further states that long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of long term investment, the carrying amount is reduced to recognise the decline.

Here, Y Ltd. lost a case of copyright which drastically reduced the realisable value of its

shares to one third which is quite a substantial figure. Losing the case of copyright may affect the business and the performance of the company in long run. Accordingly, it will be appropriate to reduce the carrying amount of long term investment by ₹ 200 lakhs and show the investments at ₹ 100 lakhs, since the downfall in the value of shares is other than temporary. The reduction of ₹ 200 lakhs in the carrying value of long term investment will be charged to the Statement of profit and loss.

Note: Students are advised to refer 'chapter 12' for problems based on practical application of AS 13.

2.4.9 Accounting for Amalgamations (AS 14)

This standard is mandatory in nature. It deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

This statement does not deal with cases of acquisitions. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

Amalgamation means an amalgamation pursuant to the provisions of the Companies Act or any other statute which may be applicable to companies.

Transferor company means the company which is amalgamated into another company.

Transferee company means the company into which a transferor company is amalgamated.

Types of Amalgamations

Amalgamations fall into two broad categories:

In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. These are known as Amalgamation in nature of merger. Other is known as Amalgamation in nature of purchase.

Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions:

- i. All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

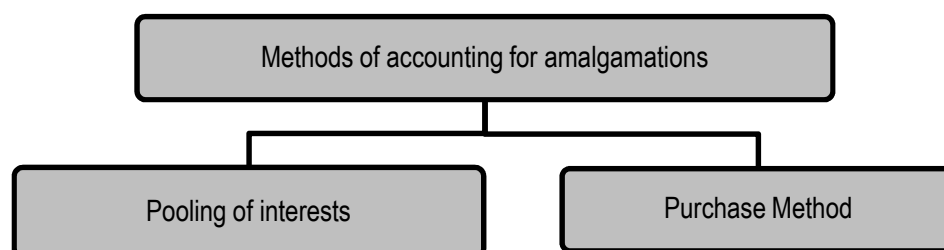
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- iii. The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- iv. The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- v. No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified above.

Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamations, viz.,



Pooling of interests

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts.

If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5.

The Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [AS 4].

Example

A Ltd. take over B Ltd. on April 01, 2015 and discharges consideration for the business as follows:

- (i) *Issued 42,000 fully paid equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.*
- (ii) *Issued fully paid up 15% preference shares of ₹ 100 each to discharge the preference shareholders (₹ 1,70,000) of B Ltd. at a premium of 10%.*
- (iii) *It is agreed that the debentures of B Ltd. (₹ 50,000) will be converted into equal number and amount of 13% debentures of A Ltd.*

Solution:

Particulars	₹	₹
Equity Shares (42,000 x 10)		4,20,000
Preference Share Capital	1,70,000	
Add : Premium on Redemption	<u>17,000</u>	<u>1,87,000</u>
Purchase Consideration		<u>6,07,000</u>

Treatment of Reserves on Amalgamation

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

If the amalgamation is an 'amalgamation in the nature of purchase', the amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve.

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In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

Certain reserves may have been created by the transferor company pursuant to the requirements of certain acts, referred to hereinafter as 'statutory reserves'. Such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Account') which is disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

Treatment of Goodwill Arising on Amalgamation

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

Illustration

The following are the summarised balance sheets of A Ltd. and B Ltd. as on March 31, 2015:

Liabilities	A Ltd. (₹)	B Ltd. (₹)
Equity Shares, ₹ 10 each, fully paid up	7,20,000	3,00,000
14% Preference Share Capital, ₹ 100 each, fully paid up	1,50,000	1,70,000
Securities Premium	1,50,000	
Capital Reserve		13,000
General Reserve	80,000	45,000
Export Profit Reserve		20,000
Profit and Loss Account	75,000	40,000
Workmen Compensation Fund		3,000
13% Debentures, ₹ 100 each, fully paid up	1,00,000	50,000
Trade payables	1,15,000	35,000
Provision for Taxation	15,000	10,000
	14,05,000	6,86,000

Assets		
Goodwill	2,00,000	60,000
Land and Buildings	2,50,000	
Plant and Machinery	3,25,000	2,70,000
Furniture and Fixtures	57,000	95,000
Inventory	2,15,000	1,75,000
Trade receivables	72,000	30,000
Income Tax Refund Claim		6,000
Cash at Bank	2,16,000	50,000
Cash in Hand	70,000	
	14,05,000	6,86,000

A Ltd. take over B Ltd. on April 01, 2015 and discharges consideration for the business as follows:

- Issued 42,000 fully paid equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.
- Issued fully paid up 15% preference shares of ₹ 100 each to discharge the preference shareholders of B Ltd. at a premium of 10%.
- It is agreed that the debentures of B Ltd. will be converted into equal number and amount of 13% debentures of A Ltd.
- The Statutory Reserve of B Ltd. is to be maintained for two more years.
- Expenses of amalgamation amounting to ₹ 15,000 are borne by A Ltd.

Solution

Since all the five conditions are satisfied, it is amalgamation in the nature of merger. Following are the journal entries in the books of A Ltd. and the calculation of the Purchase Consideration.

Particulars		Dr. (₹)	Cr. (₹)
Goodwill Account	Dr.	60,000	
Plant & Machinery Account	Dr.	2,70,000	
Furniture & Fixtures Account	Dr.	95,000	
Inventory Account	Dr.	1,75,000	
Trade receivables Account	Dr.	30,000	
IT Refund Account	Dr.	6,000	
Bank Account	Dr.	50,000	
General Reserve Account (Balancing Figure)	Dr.	52,000	

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To Capital Reserve Account			13,000
To Export Profit Reserve Account			20,000
To Workmen Compensation Fund Account			3,000
To 13% Debentures Account			50,000
To Trade payables Account			35,000
To Provision for Tax Account			10,000
To Business Purchase Account			6,07,000
Business Purchase Account Dr.	6,07,000		
To B Ltd. Liquidator Account			6,07,000
B Ltd. Liquidator Account Dr.	6,07,000		
To Equity Share Capital Account			4,20,000
To Preference Share Capital			1,87,000
13% Debentures Account (In B Ltd.) Dr.	50,000		
To 13% Debentures Account (In A Ltd.)			50,000

If we consider that the fifth point i.e. business of B Ltd. was not carried on by A Ltd. then it will be Amalgamation in the nature of Purchase and the journal entries in the books of A Ltd. will be as follow:

Particulars	Dr. (₹)	Cr. (₹)
Goodwill Account (Balancing Figure) Dr.	76,000	
Plant & Machinery Account Dr.	2,70,000	
Furniture & Fixtures Account Dr.	95,000	
Stock Account Dr.	1,75,000	
Debtors Account Dr.	30,000	
IT Refund Account Dr.	6,000	
Bank Account Dr.	50,000	
To 13% Debentures Account		50,000
To Creditors Account		35,000
To Provision for Tax Account		10,000
To Business Purchase Account		6,07,000
Business Purchase Account Dr.	6,07,000	
To B Ltd. Liquidator Account		6,07,000

B Ltd. Liquidator Account	Dr.	6,07,000	
To Equity Share Capital Account			4,20,000
To Preference Share Capital			1,87,000
13% Debentures Account (In B Ltd.)	Dr.	50,000	
To 13% Debentures Account (In A Ltd.)			50,000
Profit and Loss A/c	Dr.	15,000	
To Bank Account			15,000
Amalgamation Adjustment Account	Dr.	20,000	
To Export Profit Reserve Account			20,000

Disclosure

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

- Names and general nature of business of the amalgamating companies;
- Effective date of amalgamation for accounting purposes;
- The method of accounting used to reflect the amalgamation; and
- Particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

- Description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;
- The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

- Consideration for the amalgamation and a description of the consideration paid or contingently payable; and
- The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

Note: For problems based on practical application of AS 14, students are advised to refer 'chapter 6' of the study material.

Miscellaneous Illustrations

AS 1 Disclosure of Accounting Policies

Illustration 1

ABC Ltd. was making provision for non-moving stocks based on no issues for the last 12 months up to 31.3.2015.

The company wants to provide during the year ending 31.3.2015 based on technical evaluation:

Total value of stock ₹ 100 lakhs

Provision required based on 12 months issue ₹ 3.5 lakhs

Provision required based on technical evaluation ₹ 2.5 lakhs

Does this amount to change in Accounting Policy? Can the company change the method of provision?

Solution

The decision of making provision for non-moving stocks on the basis of technical evaluation does not amount to change in accounting policy. Requirement to provide for non-moving stocks may be said as accounting policy but the basis for making provision will not constitute accounting policy. It will be considered as an accounting estimate. Further, the method of estimating the amount of provision may be changed in case a more prudent estimate can be made.

In the given case, considering the total value of stock, the change in the amount of required provision of non-moving stock from ₹ 3.5 lakhs to ₹ 2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2014-15:

“The company has provided for non-moving stocks on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year end net assets would have been higher by ₹ 1 lakh.”

Illustration 2

Jagannath Ltd. had made a rights issue of shares in 2012. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31st March, 2014. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of ₹ 10 crores. The board in consultation with the managing director, decided on the following:

- (i) ***Value year-end inventory at works cost (₹ 50 crores) instead of the hitherto method of valuation of inventory at prime cost (₹ 30 crores).***

- (ii) *Provide depreciation for the year on straight line basis on account of substantial additions in gross block during the year, instead of on the reducing balance method, which was hitherto adopted. As a consequence, the charge for depreciation at ₹ 27 crores is lower than the amount of ₹ 45 crores which would have been provided had the old method been followed, by ₹ 18 crores.*
- (iii) *Not to provide for “after sales expenses” during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of “matching of costs against revenue” and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to ₹ 600 crores.*
- (iv) *Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being ₹ 10 crores.*

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 2013-2014.

Solution

As per AS 1, any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. Accordingly, the notes on accounts should properly disclose the change and its effect.

Notes on Accounts:

- (i) *During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at ₹ 50 crores and the profit for the year is increased by ₹ 20 crores.*
- (ii) *In view of the heavy capital intensive method of production introduced during the year, the company has decided to change the method of providing depreciation from reducing balance method to straight line method. As a result of this change, depreciation has been provided at ₹ 27 crores which is lower than the charge which would have been made had the old method and the old rates been applied, by ₹ 18 crores. To that extent, the profit for the year is increased.*

- (iii) So far, the company has been providing 2% of sales for meeting “after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by ₹ 12 crores than would have been the case if the old policy were to continue.
- (iv) The company has decided to provide ₹ 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by ₹ 10 crores.

AS 2 Valuation of Inventories

Illustration 3

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2014-15, the Historical Cost and Net Realizable Value of the items of closing stock are determined as follows:

Items	Historical Cost (₹ in lakhs)	Net Realisable Value (₹ in lakhs)
A	40	28
B	32	32
C	16	24

What will be the value of Closing Stock?

Solution

As per para 5 of AS 2 on Valuation of Inventories, inventories should be valued at the lower of cost and net realizable value. Inventories should be written down to net realizable value on an item-by-item basis in the given case.

Items	Historical Cost (₹ in lakhs)	Net Realisable Value (₹ in lakhs)	Valuation of closing stock (₹ in lakhs)
A	40	28	28
B	32	32	32
C	<u>16</u>	<u>24</u>	<u>16</u>
	<u>88</u>	<u>84</u>	<u>76</u>

Hence, closing stock will be valued at ₹ 76 lakhs.

Illustration 4

The closing inventory at cost of a company amounted to ₹ 2,84,700. The following items were included at cost in the total:

- (a) 400 coats, which had cost ₹ 80 each and normally sold for ₹ 150 each. Owing to a defect in manufacture, they were all sold after the balance sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds.
- (b) 800 skirts, which had cost ₹ 20 each. These too were found to be defective. Remedial work in April cost ₹ 5 per skirt, and selling expenses for the batch totaled ₹ 800. They were sold for ₹ 28 each.

What should the inventory value be according to AS 2 after considering the above items?

Solution**Valuation of Closing Stock**

Particulars	₹	₹
Closing Stock at cost		2,84,700
Less : Cost of 400 coats (400 x 80)	32,000	
Less: Net Realisable Value [400 x (75 – 5% of ₹75)]	<u>28,500</u>	<u>3,500</u>
Value of Closing Stock		<u>2,81,200</u>

Note: There is no adjustment for skirts because for skirts were sold at above cost.

Illustration 5

Calculate the value of raw materials and closing stock based on the following information:

<u>Raw material X</u>	
Closing balance	500 units
	<u>₹ per unit</u>
Cost price including excise duty	200
Excise duty (Cenvat credit is receivable on the excise duty paid)	10
Freight inward	20
Unloading charges	10
Replacement cost	150
<u>Finished goods Y</u>	
Closing Balance	1200 units

1.80 Accounting

	<u>₹ per unit</u>
Material consumed	220
Direct labour	60
Direct overhead	40

Total fixed overhead for the year was ₹ 2,00,000 on normal capacity of 20,000 units.

Calculate the value of the closing stock, when

- (i) Net Realizable Value of the Finished Goods Y is ₹ 400.
(ii) Net Realizable Value of the Finished Goods Y is ₹ 300.

Solution

Statement showing valuation of Raw Material and Finished Goods at cost

<i>Raw Material X</i>	₹
Cost Price	200
Less: CENVAT credit	(10)
	190
Add: Freight Inward	20
Unloading charges	10
Cost	<u>220</u>
<i>Finished goods Y</i>	₹
Materials consumed	220
Direct labour	60
Direct overhead	40
Fixed overheads (2,00,000/20,000)	10
Cost	<u>330</u>

(i) When Net Realisable Value (NRV) of the Finished Goods Y is ₹ 400

NRV is greater than the cost of Finished Goods Y i.e. ₹ 330

Hence, Raw Material and Finished Goods will be valued at cost

Accordingly, value of closing stock will be:

	Qty	Rate	Amount (₹)
Raw Material X	500	220	1,10,000
Finished Goods Y	1,200	330	<u>3,96,000</u>
Total cost of closing stock			<u>5,06,000</u>

(ii) When Net Realisable Value of the Finished Goods Y is ₹ 300

NRV is less than the cost of Finished Goods Y i.e. ₹ 330

Hence, Raw Material is to be valued at replacement cost and Finished Goods are to be valued at NRV.

Accordingly, value of closing stock will be:

	Qty	Rate	Amount (₹)
Raw Material X	500	150	75,000
Finished Goods Y	1,200	300	<u>3,60,000</u>
Total cost of closing stock			<u>4,35,000</u>

Note: It has been assumed that Raw Material X is used for production of Finished Goods Y.

AS 3 Cash Flow Statements**Illustration 6**

Classify the following activities as (1) Operating Activities, (2) Investing Activities, (3) Financing Activities:

- a. Purchase of Machinery.
- b. Proceeds from issuance of equity share capital.
- c. Cash Sales.
- d. Proceeds from long-term borrowings.
- e. Proceeds from Debtors.
- f. Brokerage paid on purchase of investments.

Solution

As per para 5 of AS 3 (Revised) "Cash Flow Statements",

Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Thus, the classification will be done as:

Operating Activities: c, e,

Investing Activities: a, f,

Financing Activities: b, d.

AS 6 Depreciation Accounting

Illustration 7

A plant was depreciated under two different methods as under:

Year	SLM (₹ in lakhs)	W.D.V. (₹ in lakhs)
1	7.80	21.38
2	7.80	15.80
3	7.80	11.68
4	7.80	8.64
	31.20	57.50
5	7.80	6.38

What should be the amount of resultant surplus/deficiency, if the company decides to switch over from W.D.V. method to SLM method for first four years? Also state, how will you treat the same in Accounts.

Solution

As per para 21 of AS 6 on Depreciation Accounting, when a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In the given case, there is a surplus of ₹ 26.30 lakhs on account of change in method of depreciation, which will be credited to Profit and Loss Account. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed

AS 7 Construction Contracts

Illustration 8

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2013.

	(₹ in lakhs)
Total Contract Price	1,000
Work Certified	500
Work not Certified	105
Estimated further Cost to Completion	495
Progress Payment Received	400
To be Received	140

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS 7 (Revised) issued by your institute.

Solution

(a)	Amount of foreseeable loss	(₹ in lakhs)
	Total cost of construction (500 + 105 + 495)	1,100
	Less: Total contract price	<u>(1,000)</u>
	Total foreseeable loss to be recognized as expense	<u>100</u>

According to para 35 of AS 7 (Revised 2002), when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

(b)	Contract work-in-progress i.e. cost incurred to date are ₹ 605 lakhs	(₹ in lakhs)
	Work certified	500
	Work not certified	<u>105</u>
		<u>605</u>
	This is 55% $(605/1,100 \times 100)$ of total costs of construction.	

- (c) Proportion of total contract value recognised as revenue as per para 21 of AS 7 (Revised).

55% of ₹ 1,000 lakhs = ₹ 550 lakhs

- (d) Amount due from/to customers = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)
- $$= [605 + \text{Nil} - 100 - (400 + 140)] \text{ ₹ in lakhs}$$
- $$= [605 - 100 - 540] \text{ ₹ in lakhs}$$

Amount due to customers = ₹ 35 lakhs

The amount of ₹ 35 lakhs will be shown in the balance sheet as liability.

- (e) The relevant disclosures under AS 7 (Revised) are given below:

	₹ in lakhs
Contract revenue	550
Contract expenses	605
Recognised profits less recognized losses	(100)
Progress billings (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35

Illustration 9

On 1st December, 2014, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2015 the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. Calculate total estimated loss on contract and what amount should be charged to revenue in the final accounts for the year ended 31st March, 2015 as per provisions of Accounting Standard 7 (Revised)?

Solution**Calculation of estimated total loss and amount charged to revenue**

	₹
Cost incurred till 31 st March, 2015	64,99,000
Prudent estimate of additional cost for completion	<u>32,01,000</u>
Total cost of construction	97,00,000
Less: Contract price	<u>(85,00,000)</u>
Total foreseeable loss	<u>12,00,000</u>

According to para 35 of AS 7 (Revised 2002), the amount of ₹ 12,00,000 is required to be recognized as an expense.

$$\text{Contract work in progress} = \frac{\text{₹ } 64,99,000 \times 100}{97,00,000} = 67\%$$

Proportion of total contract value recognized as turnover as per para 21 of AS 7 (Revised) on Construction Contracts.

$$= 67\% \text{ of ₹ } 85,00,000 = \text{₹ } 56,95,000.$$

AS 9 Revenue Recognition**Illustration 10**

Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2014-15.

You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

Solution

As per para 13 of AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

- (i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.
- (ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.

Illustration 11

SCL Ltd., sells agriculture products to dealers. One of the condition of sale is that interest is payable at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2013-2014 the company wants to recognise the entire interest receivable. Do you agree?

Solution

As per para 9.2 of AS 9 on Revenue Recognition, where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc, revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

Thus, SCL Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstandings is also an estimate and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.

AS 10 Accounting for Fixed Assets**Illustration 12**

During the current year 2014–2015, X Limited made the following expenditure relating to its plant building:

	₹ In lakhs
Routine Repairs	4
Repairing	1
Partial replacement of roof tiles	0.5
Substantial improvements to the electrical wiring system which will increase efficiency	10

What amount should be capitalized?

Solution

As per para 12.1 of AS 10 on Accounting for Fixed Assets, expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity. Hence, in the given case, Repairs amounting ₹ 5 lakhs and Partial replacement of roof tiles should be charged to profit and loss statement. ₹ 10 lakhs incurred for substantial improvement to the electrical wiring system which will increase efficiency should be capitalized.

Illustration 13

J Ltd. purchased machinery from K Ltd. on 30.09.2013. The price was ₹ 370.44 lakhs after charging 8% Sales-tax and giving a trade discount of 2% on the quoted price. Transport charges were 0.25% on the quoted price and installation charges come to 1% on the quoted price.

A loan of ₹ 300 lakhs was taken from the bank on which interest at 15% per annum was to be paid.

Expenditure incurred on the trial run was Materials ₹ 35,000, Wages ₹ 25,000 and Overheads ₹ 15,000.

Machinery was ready for use on 1.12.2013. However, it was actually put to use only on 1.5.2014. Find out the cost of the machine and suggest the accounting treatment for the expenses incurred in the interval between the dates 1.12.2013 to 1.5.2014. The entire loan amount remained unpaid on 1.5.2014.

Solution

	₹ (in Lakhs)	(₹ in Lakhs)	
Quoted price (refer to working note)	350.00		
Less: 2% Trade Discount	<u>(7.00)</u>		
	343.00		
Add: 8% Sales tax (8% × ₹ 343 lakhs)	<u>27.44</u>	370.44	
Transport charges (0.25% × ₹ 350 lakhs)		0.88	(approx.)
Installation charges (1% × ₹ 350 lakhs)		3.50	
Financing cost (15% on ₹ 300 Lakhs) for the period 30.9.2013 to 1.12.2013		7.50	
Trial Run Expenses			
Material	0.35		
Wages	0.25		
Overheads	<u>0.15</u>	<u>0.75</u>	
Total cost		<u>383.07</u>	

Interest on loan for the period 1.12.2013 to 1.05.2014 is ₹ 300 lakhs $\times \frac{15}{100} \times \frac{5}{12} = ₹ 18.75$ lakhs

This expenditure may be charged to Profit and Loss Account or deferred for amortization between say three to five years. It has been assumed that no other expenses are incurred on the machine during this period.

Working Note:

Let the quoted price 'X'

Less: Trade Discount 0.02X.

Actual Price = 0.98X.

Sale Tax @8% = 1.08 × 0.98X

or X = $\frac{₹ 370.44 \text{ lakhs}}{1.08 \times 0.98} = ₹ 350 \text{ lakhs}$

AS 13 Accounting for Investments

Illustration 14

While preparing the financial statements of R Ltd. for the year ended 31st March, 2015, you come to know that an unquoted long term investment is carried in the books at a cost of ₹ 2 lakhs. The published accounts of the unlisted company received in May, 2015 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 20,000. How you would deal with this in the financial statements?

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2015 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Para 17 of AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to ₹ 20,000 in the financial statements for the year ended 31st March, 2015.

Illustration 15

Saksham Ltd. wants to re-classify its Investment in accordance with AS 13. Decide on the treatment to be given in each of the following cases assuming that the market value has been determined in an arm's length transaction between knowledgeable and willing buyer and seller:

- (i) *A portion of Current Investments purchased for ₹ 10 lakhs to be reclassified as long-term Investments, as the company has decided to retain them. The market value as on the date of Balance Sheet was ₹ 12 lakhs.*
- (ii) *Another portion of Current Investments purchased for ₹ 8 lakhs has to be re classified as Long-term Investments. The market value of these investments as on the date of Balance Sheet was ₹ 5 lakhs.*

Solution

As per para 24 of AS 13 'Accounting for Investments', where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

- (i) In the first case, the market value of the investment is ₹ 12 lakhs, which is higher than its cost i.e. ₹ 10 lakhs. Therefore, the transfer to long term investments should be made at cost i.e. ₹ 10 lakhs.
- (ii) In the second case, the market value of the investment is ₹ 5 lakhs, which is lower than its cost i.e. ₹ 8 lakhs. Therefore, the transfer to long term investments should be made in the books at the market value i.e. ₹ 5 lakhs. The loss of ₹ 3 (8 – 5) lakhs should be charged to profit and loss account.

Reference: *The students are advised to refer the full text of AS 1, 2, 3, 6, 7, 9, 10, 13 and 14 given in Appendix I.*